Lloyds Banking Group plc
Form 20-F
May 13, 2011

As filed with the Securities and Exchange Commission on 13 May 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

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

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended 31 December 2010

OR

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

OR

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

Commission file number 001-15246

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

Scotland
(Jurisdiction of Incorporation or Organization)

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

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

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

4.875% Senior Notes due 2016	The New York Stock Exchange
6.375% Senior Notes due 2021	The New York Stock Exchange
Floating Rate Notes due 2014	The New York Stock Exchange

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

None

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

None

The number of outstanding shares of each of Lloyds Banking Group plc s classes of capital or common stock as of 31 December 2010 was:

Ordinary shares, nominal value 10 pence each	68,074,129,454
Limited voting shares, nominal value 10 pence each	80,921,051
Preference shares, nominal value 25 pence each	412,215,065
Preference shares, nominal value 25 cents each	1,917,280
Preference shares, nominal value 25 euro cents each	173,350

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

Yes x No o

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

Yes o No x

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

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

Yes x No o

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

Yes o No o

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

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

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

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

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

Item 17 o Item 18 o

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

Yes o No x

TABLE OF CONTENTS

PRESENTATION OF INFORMATION

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

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds (pounds sterling , sterling or £), the lawful currency of the UK. In this annual report, references to pence and p are to one-hundredth of one pound sterling; references to US dollars , US$ or $ are to the lawful currency of the United States (the US); references to cent or c are to one-hundredth of one US dollar; references to euro or e are to the lawful currency of the member states of the European Union that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to euro cent are to one-hundredth of one euro; and references to Japanese yen , Japanese ¥ or ¥ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2010, which was $1.5392 = £1.00. The Noon Buying Rate on 31 December 2010 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

BUSINESS OVERVIEW

Lloyds Banking Group is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to personal and corporate customers. At 31 December 2010, total Lloyds Banking Group assets were £992,438 million and Lloyds Banking Group had some 104,230 employees (on a full-time equivalent basis). Lloyds Banking Group plc s market capitalisation at that date was some £44,725 million. The Group reported a loss before tax for the 12 months to 31 December 2010 of £2,919 million, as a result of a provision of £3,200 million in relation to payment protection insurance, and the capital ratios as at that date were 14.5 per cent for total capital, 11.0 per cent for tier 1 capital and 9.6 per cent for core tier 1 capital.

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

	2010	2009	2008[1]
	£m	£m	£m
Net interest income	**12,546**	9,026	7,718
Other income	**30,921**	36,271	(709)
Total income	**43,467**	45,297	7,009
Insurance claims	**(18,511)**	(22,019)	2,859
Total income, net of insurance claims	**24,956**	23,278	9,868
Operating expenses	**(16,470)**	(15,984)	(6,100)
Trading surplus	**8,486**	7,294	3,768
Impairment	**(10,952)**	(16,673)	(3,012)
Share of results of joint ventures and associates	**(88)**	(752)	4
Gain on acquisition		11,173	
Loss on disposal of businesses	**(365)**		
Loss (profit) before tax	**(2,919)**	1,042	760

1 Restated in 2009 for IFRS 2 (Revised).

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

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

The acquisition of HBOS plc on 16 January 2009 had a significant effect on the comparability of the Group s financial position and results with prior periods. Profit before tax is analysed further on pages 13 to 26 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group s segments, on pages 28 to 46 on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described on page 28. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group s internal reporting based around these segments (which reflect the Group s organisational and management structures) in order to assess performance and allocate resources; this reporting is on a combined businesses basis, which the Group Executive Committee feel best represents the underlying performance of the Group. These combined businesses segmental results for 2010, 2009 and 2008 are therefore presented in compliance with IFRS 8 but the aggregated total of the combined businesses segmental results constitutes a non-GAAP measure as defined in the SEC s Regulation G and a reconciliation of this aggregated total to the statutory income statement is therefore provided on page 47. The following table shows the results of Lloyds Banking Group s Retail, Wholesale, Wealth and International, and Insurance segments and Group Operations and Central items in the last three fiscal years, and their aggregation.

	2010	2009	2008
	£m	£m	£m
Retail	**4,716**	1,382	2,542
Wholesale	**3,257**	(4,703)	(10,479)
Wealth and International	**(4,824)**	(2,356)	277
Insurance	**1,102**	975	1,540
Group Operations and Central items:			
Group Operations	**(63)**	(149)	(76)
Central items	**(1,976)**	(1,449)	(517)
	(2,039)	(1,598)	(593)
Profit (loss) before tax Combined businesses basis	**2,212**	(6,300)	(6,713)

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

SELECTED CONSOLIDATED FINANCIAL DATA

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

	2010	2009	2008[1]	2007[1]	2006[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**24,956**	23,278	9,868	10,696	11,098
Operating expenses	**(16,470)**	(15,984)	(6,100)	(5,568)	(5,300)
Trading surplus	**8,486**	7,294	3,768	5,128	5,798
Impairment losses	**(10,952)**	(16,673)	(3,012)	(1,796)	(1,555)
Gain on acquisition		11,173			
(Loss) profit before tax	**(2,919)**	1,042	760	3,999	4,249
(Loss) profit for the year	**(2,594)**	2,953	798	3,320	2,908
(Loss) profit for the year attributable to equity shareholders	**(2,656)**	2,827	772	3,288	2,804
Total dividend for the year[2]			648	2,026	1,928
Balance sheet data at 31 December (£m)					
Share capital	**6,815**	10,472	1,513	1,432	1,429
Shareholders equity	**43,725**	43,278	9,393	12,141	11,155
Customer deposits	**393,633**	406,741	170,938	156,555	139,342
Subordinated liabilities	**36,232**	34,727	17,256	11,958	12,072
Loans and advances to customers	**592,597**	626,969	240,344	209,814	188,285
Total assets	**992,438**	1,027,255	436,033	353,346	343,598
Share information					
Basic earnings per ordinary share[3]	**(4.0)p**	7.5p	6.7p	28.9p	24.8p
Diluted earnings per ordinary share[3]	**(4.0)p**	7.5p	6.6p	28.7p	24.5p
Net asset value per ordinary share	**64p**	68p	155p	212p	195p
Total dividend per ordinary share[2]			11.4p	35.9p	34.2p
Equivalent cents per share[2,4]			20.3c	71.0c	67.0c
Market price per ordinary share (year end)	**65.7p**	50.7p	126.0p	472.0p	571.5p
Number of shareholders (thousands)	**2,798**	2,834	824	814	870
Number of ordinary shares in issue (millions)[5]	**68,074**	63,775	5,973	5,648	5,638
Financial ratios (%)[6]					
Dividend payout ratio			83.9	61.6	68.7
Post-tax return on average shareholders equity	**(5.8)**	8.8	7.0	28.1	26.6
Post-tax return on average assets	**(0.25)**	0.28	0.21	0.94	0.88
Average shareholders equity to average assets	**4.5**	3.0	2.9	3.3	3.2
Cost:income ratio[7]	**66.0**	68.7	61.8	52.1	47.8
Capital ratios (%)[8,9]					
Total capital	**14.5**	12.4	11.1	11.0	10.7
Tier 1 capital	**11.0**	9.6	7.9	8.1	8.2

1 Restated in 2009 for IFRS 2 (Revised) (see note 1 on page F-11).

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] Earnings per share calculations for 2008 and earlier years have also been restated for the impact of the bonus element of the share issues in 2009.

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

[5] This figure excludes the limited voting ordinary shares owned by the Lloyds TSB Foundations.

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

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

[8] Capital ratios are in accordance with Basel II requirements other than the ratios for 2007 and 2006 which reflect Basel I.

[9] Capital ratios for 2008 and 2009 were restated in 2010 to reflect a prior year adjustment to available-for-sale revaluation reserves (see note 1 on page F-11).

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:

	2011 April	2011 March	2011 February	2011 January	2010 December	2010 November
US dollars per pound sterling:						
High	**1.67**	**1.64**	**1.62**	**1.60**	**1.59**	**1.63**
Low	**1.61**	**1.60**	**1.60**	**1.55**	**1.54**	**1.56**

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

	2010	2009	2008	2007	2006
US dollars per pound sterling:					
Average	**1.54**	1.57	1.84	2.01	1.86

On 6 May 2011, the latest practicable date, the US dollar Noon Buying Rate was $1.6417 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company s issued ordinary share capital. Following further issues of ordinary shares, the UK Government s holding has been reduced to approximately 40.6 per cent.

STRATEGY OF LLOYDS BANKING GROUP

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

The main focus for the Group remains the financial services markets in the UK and the Group s strategic position was strengthened through the acquisition of HBOS in January 2009. The Group is a well diversified UK financial services group and the largest retail financial services provider in the UK. The Group has leading positions in many of the markets in which it participates, a comprehensive distribution capability, well recognised brands and a large customer base. The Group continues to invest in products and services, systems and training that combined will offer improved choice and service to the Group s customers.

The Group s corporate strategy is focused on:

DEVELOPING STRONG CUSTOMER FRANCHISES THAT ARE BASED ON DEEP CUSTOMER RELATIONSHIPS

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

BUSINESS

BUILDING A HIGH PERFORMANCE ORGANISATION

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

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

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

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

MANAGING THE GROUP S MOST VALUABLE RESOURCE, PEOPLE

Central to executing the Group s strategy effectively will be building strong and long lasting customer relationships; this will only be possible through the efforts of its people. Therefore the Group s employees are its most valuable resource and it must ensure that their objectives and deliverables are aligned to the Group s corporate strategy. In driving a high performance culture it is important to encourage, manage and develop staff whilst creating a great place to work. By creating a great place to work the Group believes it will be able to retain and attract the highest performers.

SUMMARY

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

Following the appointment of António Horta-Osório as Group Chief Executive of Lloyds Banking Group on 1 March 2011, the Group has also announced the launch of a Strategic Review of its Medium Term Plan (see *Recent developments Lloyds Banking Group moves ahead with Project Verde*). The conclusions of the Strategic Review will be announced around the end of the first half of 2011. The Strategic Review will cover all aspects of the business and will focus on ensuring that customers will be at the heart of the Group s future strategy by supporting UK households and businesses.

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

The Group is organised into four segments: Retail; Wholesale; Wealth and International; and Insurance; see note 4 to the consolidated financial statements.

Further information on the Group s segments is set out on pages 33 to 44.

MATERIAL CONTRACTS

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

In 2009, the Company entered into a placing and compensatory open offer agreement with Her Majesty s Treasury (HM Treasury) (as amended and restated on 20 March 2009 between the Company, HM Treasury, Citigroup Global Markets U.K. Equity Limited, J.P. Morgan Cazenove Limited and UBS Limited and further amended and restated between the same parties on 18 May 2009). In addition, the Company entered into a registration rights agreement with HM Treasury on 12 January 2009 (as amended with effect from 11 June 2009). The Company also entered into a resale rights agreement with HM Treasury pursuant to its obligations under the 2009 placing and compensatory open offer agreement. In addition, in connection with the Rights Issue completed in 2009 and the Group s withdrawal from its proposed participation in the Government Asset Protection Scheme, the Company entered into a GAPS withdrawal deed with HM Treasury as well as the HMT undertaking to subscribe and the cost reimbursement deed. For further details on each of the 2009 agreements described above, see *Major shareholders and related party transactions*

Information about Lloyds Banking Group s Relationship with the UK Government.

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

RIGHTS ISSUE UNDERWRITING AGREEMENT

Pursuant to an underwriting agreement dated 3 November 2009 (entered into in relation to the Rights Issue between the Company, the banks, the senior co-lead managers, the co-lead managers and the co-bookrunner (all as named therein)), new shares in the Company were issued at a price of 37 pence per share. Sufficient new shares were issued to ensure that the gross proceeds of the Rights Issue receivable by the Company, including pursuant to the HMT Undertaking to Subscribe, were not less than £13.5 billion.

HM Treasury undertook to subscribe for its pro rata entitlement under the Rights Issue and the new shares that were the subject of the HMT Undertaking to Subscribe were not underwritten pursuant to the Rights Issue Underwriting Agreement. Further details of the HMT Undertaking to Subscribe are set out in *Major Shareholders and Related Party Transactions Information about Lloyds Banking Group s Relationship with the UK Government*.

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

BUSINESS

The Company agreed to pay all costs and expenses of, or in connection with, the Rights Issue, the general meeting of the Company convened to approve the Rights Issue, the related subdivision of the Company s shares, the allotment and issue of the new shares and the Rights Issue Underwriting Agreement, including (but not limited to) the UK Listing Authority and the London Stock Exchange listing and trading fees, other regulatory fees and expenses, printing and advertising costs, postage, Equiniti Limited s charges (as registrar), its own and the banks , the senior co-lead managers and the co-lead managers properly incurred legal and other out of-pocket expenses, all accountancy and other professional fees, properly incurred public relations fees and expenses and all stamp duty and stamp duty reserve tax (if any) and other duties and taxes (other than corporation tax incurred by any of the banks, the senior co-lead managers and the co-lead managers on the commissions payable to them).

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

TOP UP ISSUES UNDERWRITING AGREEMENT

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

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

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

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

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

(i) an aggregate transaction praecipuum of 0.088 per cent of £15.1 billion (being the aggregate of the underwriting commitments of the underwriters and the joint bookrunners), or of a sum in excess thereof dependent on the notional amount of the securities submitted in the Exchange Offers; and

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

ENVIRONMENTAL MATTERS

The Group believes that it has an important role to play in facilitating and financing the transition to a low carbon, resource efficient economy. The Group s vision is to be recognised by its stakeholders as a leading environmentally responsible organisation.

The Group is already one of the leading global financers of renewable energy (by debt underwriting capability). In 2010, Lloyds Banking Group was rated the top UK bank in the new FTSE Carbon Disclosure Project (CDP) Carbon Strategy Index Series, recognising its performance in managing climate risks and grasping the emerging opportunities.

GOVERNANCE

The Group strengthened its governance framework in 2010, establishing Board representatives for key strands of its Corporate Responsibility agenda, including environmental management. Truett Tate, Group Executive Director, Wholesale, is Executive Sponsor for Climate Change and Environmental Issues. The Group also established a new Environmental Steering Group, chaired by the Group Property Director. With senior representation from across the Group, this drives the environmental strategy, targets and performance.

MANAGING ENVIRONMENTAL RISKS IN LENDING

The Group has introduced policies and procedures to reduce the environmental impact of its lending activities. The groupwide Environmental Risk Policy requires all business loans to be assessed for material environmental risks as part of the credit sanctioning process. The Group s policy is supported by a robust process which ensures that there is a consistent approach to identifying, assessing, mitigating and reporting environmental risks. Lending officers are responsible for ensuring that environmental risks are assessed and that action is taken where a risk is identified. Employees are trained in environmental risk management as part of the Group s standard credit risk training course and have access to relevant guidance documents. In 2011, the Group will further strengthen its risk management process with the implementation of an online environmental risk screening tool.

PROJECT FINANCE: EQUATOR PRINCIPLES

Lloyds Banking Group is a signatory to the Equator Principles to support its approach to assessing and managing environmental and social issues in project finance. Lending officers are responsible for undertaking initial classification of transactions that qualify under the Equator Principles. Their assessments are subject to further review by the Group s Equator Principles Review Group, comprising experts from both the Risk and Project Finance teams, to ensure that each transaction is compliant and is consistent with the Group s Environmental Risk Policy. The Group trained over 100 employees in its Equator Principle Procedures in 2010.

BUSINESS

Equator Principles reporting January to December 2010:

DEALS

CATEGORY[1]	A	B	C	Total
Completed		8	10	18
In progress		4		4
Not completed		5	2	7
Total		17	12	29
GEOGRAPHY OF COMPLETED TRANSACTIONS				
US		3	2	5
Europe		5	8	13
Rest of World				
Total		8	10	18

INDUSTRY OF COMPLETED TRANSACTIONS

	Number	£m
Renewables	8	391
Infrastructure	8	699
Energy and utilities	2	78
Total	18	1,168

1 Category A is higher risk; category B is medium risk; category C is lower risk.

RESOURCE EFFICIENCY

Reducing the Group s own use of resources helps the Group minimise its impact on the environment as well as keeping costs under control. In 2010, the Group launched Smart & Responsible, its new targeted environmental action plan. It aims to deliver significant environmental and cost savings, as well as improving colleagues work-life balance.

The Group also registered for the Carbon Reduction Commitment Energy Efficiency Scheme in 2010 and will now be required to purchase allowances for each tonne of energy-related CO_2 that it emits. This has significant cost implications for the Group which provides a further incentive to reduce carbon emissions. The Group is already working towards achieving the Carbon Trust Standard this standard recognises organisations that are genuinely measuring and reducing CO_2 emissions. The Group s goal is to reduce its energy consumption by 30 per cent by 2020.

ENGAGING OUR EMPLOYEES

Employees play a key role in delivering the Group s environmental agenda. One of the main areas where colleagues can have a real impact is in business travel. There is a common travel policy in place across the Group which supports a focus on reducing travel. This has helped to increase the volume of teleconferences by 73 per cent in 2010 compared with 2009.

The Group has strengthened its approach in 2010 with the introduction of TRAVELwise, part of the Smart & Responsible programme. The Group has set a TRAVELwise target to avoid 1 in 5 business flights by 2015.

CO_2 EMISSIONS (TONNES)

	2010	2009
Total UK CO_2 emissions	**442,535**	449,207
Scope 1 emissions	**73,182**	76,387
Scope 2 emissions	**333,315**	343,693
Scope 3 emissions	**36,038**	29,127

For 2009, the Group has reported emissions for January to December. For 2010 and future years, the Group will report annual emissions from October to September. The Group s CO_2 emissions have been independently verified by environmental consultants, RPS Group.

PROPERTIES

As at 31 December 2010, Lloyds Banking Group occupied 3,231 properties in the UK. Of these, 928 were held as freeholds, 91 as long-term leaseholds and 2,212 as short-term leaseholds. The majority of these properties are retail branches, widely distributed throughout England, Scotland and Wales. Other buildings include the Lloyds Banking Group s head office in the City of London 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 498 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as short-term leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis, principally in North America, Europe and Asia.

LEGAL ACTIONS AND REGULATORY MATTERS

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

UNARRANGED OVERDRAFT CHARGES

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

BUSINESS

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

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

INTERCHANGE FEES

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

PAYMENT PROTECTION INSURANCE

There has been extensive scrutiny of the Payment Protection Insurance (PPI) market in recent years.

In October 2010, the UK Competition Commission confirmed its decision to prohibit the active sale of PPI by a distributor to a customer within seven days of a sale of credit. This followed the completion of its formal investigation into the supply of PPI services (other than store card PPI) to non-business customers in the UK in January 2009 and a referral of the proposed prohibition to the Competition Appeal Tribunal. The Competition Commission consulted on the wording of a draft order to implement its findings from October 2010, and published the final Order on 24 March 2011 which became effective on 6 April 2011. Following an earlier decision to stop selling single premium PPI products, the Group ceased to offer PPI products to its customers in July 2010.

On 29 September 2009 the FSA announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. Lloyds Banking Group agreed in principle that it would undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. That review will now form part of the ongoing PPI work referred to below.

On 1 July 2008, the Financial Ombudsman Service (FOS) referred concerns regarding the handling of PPI complaints to the Financial Services Authority (FSA) as an issue of wider implication. On 29 September 2009 and 9 March 2010, the FSA issued consultation papers on PPI complaints handling. The FSA published its Policy Statement on 10 August 2010, setting out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress, as well as a requirement for firms to reassess historically rejected complaints which had to be implemented by 1 December 2010.

On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008.

Subsequent to the year end, the Judicial Review hearing was held in late January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA s application. On 9 May 2011, the BBA confirmed that the banks and the BBA did not intend to appeal the judgment.

Since publication of the judgment, the Group has been in discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group has conducted of compliance with applicable sales standards, which is continuing, the Group has concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group has made a provision in its income statement for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. There are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of detailed implementation of the Policy Statement for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

US SANCTIONS

In January 2009 Lloyds TSB Bank plc announced the settlement it had reached with the US Department of Justice and the New York County District Attorney s Office in relation to their investigations into historic US dollar payment practices involving countries, persons or entities subject to the economic sanctions administered by the US Office of Foreign Assets Control (OFAC). On 22 December 2009 OFAC announced the settlement it had reached with Lloyds TSB Bank plc in relation to its investigation and confirmed that the settlement sum due to OFAC had been fully satisfied by

BUSINESS

Lloyds TSB Bank plc s payment to the Department of Justice and the New York County District Attorney s Office. No further enforcement actions are expected in relation to the matters set out in the settlement agreements.

On 26 February 2009, a purported shareholder filed a derivative civil action in the Supreme Court of New York, Nassau County against certain current and former directors, and nominally against Lloyds TSB Bank plc and Lloyds Banking Group plc, seeking various forms of relief. The derivative action is at an early stage and settlement is being discussed, and the ultimate outcome is not expected to have a material impact on the Group.

CUSTOMER GOODWILL PAYMENTS

The Group has been in discussions with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the Halifax brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F (7) of FSMA 2000. The Group has made a provision of £500 million within its 2010 accounts which is expected to fully cover the payments under this contact programme.

INTERBANK OFFERED RATE SETTING INVESTIGATIONS

Various regulators in the UK, US and overseas, including the US Commodity Futures Trading Commission, the SEC and the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates. The Group, and/or its subsidiaries, were (at the relevant time) and remain members of various panels that submit data to these bodies in a number of jurisdictions. The Group has received requests from some regulators for information and is co-operating with their investigations. In addition recently the Group has been named in private purported class action suits in the US with regard to the setting of London interbank offered rates (LIBOR) by members of the LIBOR setting panel. It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or purported private class action suits, including the timing and scale of the potential impact of any investigations and class action suits on the Group.

OTHER LEGAL ACTIONS AND REGULATORY MATTERS

In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters including complaints handling, packaged bank accounts, product terms and sales processes. The Group is keen to ensure that any regulatory concerns regarding the Group s processes, product governance, sales processes or contract terms are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

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

COMPETITIVE ENVIRONMENT

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

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

RECENT DEVELOPMENTS

LLOYDS BANKING GROUP MOVES AHEAD WITH PROJECT VERDE

On 1 March 2011, the Group made the following announcement with respect to Project Verde:

In order to meet its obligations under the state aid commitments and to ensure the Group maintains the maximum flexibility in its options, Lloyds Banking Group is accelerating the start of the disposal of the business described in more detail within *Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK government Other related party transactions with the UK government State aid*.

Moving ahead with the disposal follows the excellent progress the bank has made on integration.

Following the appointment of António Horta-Osório as Group Chief Executive of Lloyds Banking Group on 1 March 2011, the Group has also announced the launch of a Strategic Review of its Medium Term Plan. The conclusions of the Strategic Review will be announced around the end of the first half of 2011.

The Strategic Review will cover all aspects of the business and will focus on ensuring that customers will be at the heart of the Group s future strategy by supporting UK households and businesses.

To support this commitment, the Group will place a moratorium on announcing further UK branch closures until the end of 2011 and pending the Strategic Review.

BUSINESS

LLOYDS BANKING GROUP ANNOUNCES BOARD AND MANAGEMENT TEAM CHANGES

On 9 March 2011, the Group announced changes to the Group Board and management team.

Mr Archie Kane, Group Executive Director for Insurance and Scotland will not seek re-election as a Director at the Group s Annual General Meeting on 18 May 2011.

The components of the Insurance division of the Group, Life, Pensions and Investments and General Insurance, will report directly to the Group Chief Executive António Horta-Osório.

In addition as a result of a restructure of the retail bank outlined below, Mrs Helen Weir, Group Executive Director for Retail, has decided to leave the Group and will consequently not seek re-election as a Director at the Group s Annual General Meeting.

The Group s Retail banking division will now be restructured as follows:

Retail Products and Marketing.

The Lloyds TSB and Bank of Scotland Community Banks.

The Halifax Community Bank.

All of which will report directly to the Group Chief Executive.

CONSOLIDATED FINANCIAL STATEMENTS SET OUT IN THE GROUP S ANNUAL REPORT AND ACCOUNTS

The audited consolidated financial statements set forth in the Group s Annual Report and Accounts published on 30 March 2011 were approved on 24 February 2011. As discussed in greater detail in note 59 on page F-124 of the audited consolidated financial statements included in this Annual Report on Form 20-F (which were approved on 13 May 2011 and which therefore include the impact of adjusting post balance sheet events up to this date), the Group has made a provision of £3,200 million in connection with the sale of payment protection insurance following a UK High Court judgment handed down on 20 April 2011, subsequent discussions with the FSA and analyses prepared by the Group.

LLOYDS BANKING GROUP RESPONDS TO THE INTERIM REPORT FROM THE INDEPENDENT COMMISSION ON BANKING

On 11 April 2011, the Group published the following response to the Interim Report from the Independent Commission on Banking (ICB):

The Group has reviewed the Interim Report from the ICB and will consider and respond to the options presented more fully in due course. The Group will continue to play a constructive role in the debate and to consult with the ICB during the coming months.

The Group notes the ICB s desire to ensure the stability of the financial system through a form of subsidiarisation and strengthened capital. The Group will consider the financial and non-financial impact of these measures in order that the implications are fully understood.

The Group believes that the UK retail banking market is competitive and that the ICB should now seriously consider the importance of Independent Financial Advisers and of the internet channel as forces that promote competition. The Group welcomes the focus on improving switching and greater transparency that should be positive for customers of banks and is consistent with the Group s submissions to the ICB.

The Group believes that the Interim Report s option for an expansion of the divestiture of 600 branches as mandated by the European Union (Project Verde) would not be in the interest of its customers and appears to be based on limited evidence and may significantly delay meeting the commitments agreed between the UK Government and the European Union.

Project Verde will result in the creation of the seventh largest retail bank in the UK. The European Union, working with the UK Government, structured Project Verde to ensure the divested entity would specifically be a strong and viable competitor. Moreover, the Group s acceleration of the start of Project Verde is expected to identify a potential purchaser by the end of 2011.

FIRST QUARTER 2011 TRADING UPDATE

See the Group s Form 6-K relating to its first quarter 2011 trading update filed with the Securities and Exchange Commission on 13 May 2011.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

TABLE OF CONTENTS

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OVERVIEW AND TREND INFORMATION

THE ECONOMY

The global economy has continued to recover from the deep recession of 2009, but the recovery is fairly weak by past standards and its continuation is not assured. Remaining vulnerabilities in the sustainability of public finances and the robustness of banking sectors across the US and Europe have meant that growth there has faltered during 2010 and required monetary policy to be kept highly accommodative for longer than expected at the start of the year. Ireland has required support from the IMF and EU, and other high deficit countries in the Eurozone may do so during 2011. The US has extended the Bush-era tax cuts, although it is unclear how much stimulus this will provide given the need to tighten fiscal policy significantly in the medium term.

First estimates suggest that the UK economy grew by 1.4 per cent in 2010, below the long-term average of 2.25 per cent. Growth peaked in the first half due to the initial boost from companies beginning to rebuild stocks, and has slowed during the second half. Consumer confidence has fallen back and house prices have recently reversed some of their 2009 rise. Nevertheless, employment has held up relatively well, falling by much less than in previous recessions and beginning to rise much earlier, although the recent trend is broadly flat. UK corporate liquidations have been on a gradually falling trend since Q3 2009, much earlier than in previous recoveries, and are now almost back to the level at the start of the recession. Related to that, commercial property prices have now risen by 16 per cent from the trough reached in July 2009. Even though house price rises have fallen back slightly recently, average prices are still 6 per cent above their trough of April 2009.

The Group s central scenario is for the modest recovery in the UK to continue the projection of slightly less than 2 per cent Gross Domestic Product (GDP) growth in 2011 and slightly less than 2.5 per cent in 2012 is close to consensus and the March 2011 forecasts from the Office for Budget Responsibility. Private and public sector deleveraging, which is expected to suppress economic growth, should be more than offset by a positive contribution from net external trade (reflecting the weakness of sterling), by further rebuilding of stocks by companies and by increased investment. Public spending cuts may increase unemployment slightly in 2011, but if the economy continues to grow, the private sector should be able to more than offset that impact from 2012. Similarly, further declines in corporate insolvencies are likely to be very slow, limited by the public spending cuts and the weakness of consumer spending. House prices and commercial property prices are expected to dip slightly in 2011 and then rise slowly. The US recovery is assumed to continue in 2011, and in the Eurozone there is expected to be a wide divergence in 2011 between recovery in the stronger low-deficit countries and the higher deficit countries that will struggle to grow at all. The Irish economy, to which the Group has exposure, is not expected to grow materially in 2011. House prices there are expected to fall a little further in 2011 before flattening in 2012; commercial property prices are expected to be flat over 2011 and 2012.

Downside risks around this scenario remain significant. Business and consumer confidence remains fragile, and the extent to which simultaneous fiscal tightening across Europe might undermine global and UK growth is unclear. Contagion from the Irish bail-out to other Eurozone economies could drive further fiscal tightening and worsen the outlook further. Rising oil and other commodity prices, driven by strong recovery in Asia and the unrest in the Middle East, might fuel a further increase in inflation in the West, prompting short-term interest rates to rise more quickly than anticipated. Since any shock to growth would also worsen the outlook for both public finances and bank capital and funding, a relatively small initial shock could throw economies onto a much weaker path as governments are forced to tighten fiscal policy even further or financial institutions are constrained in their ability to lend. A double-dip scenario a second shallower recession following closely the one that the economy is just emerging from would result in further significant increases in corporate failures and unemployment during 2011-12. In addition, residential and commercial property would suffer a second period of falling prices, tenant defaults would increase and central banks would have limited ability to cushion the downturn.

IMPACT ON THE LLOYDS BANKING GROUP S MARKETS

The weak economic recovery in the UK has kept growth in the Group s core markets subdued.

On the retail side, net new mortgage lending (all new lending minus repayments) continued to weaken slightly after a 72 per cent fall in 2009, so outstanding market balances grew by just 0.4 per cent. Net new unsecured consumer lending improved in 2010 after turning negative in the second half of 2009, but at £2.5 billion was only 18 per cent of the 2007 level. Part of the weakness in lending is the natural result of some lenders having left the market, particularly in the higher risk segments of mortgages and personal loans, but we have also seen a continued desire from customers to repay debt early where they are able. Deposit market growth has also remained weak, with balances rising by 3 per cent through 2010, as deteriorating disposable incomes have squeezed savings flows.

Businesses also continue to reduce their indebtedness. Non-financial corporations shrunk their borrowings from banks and building societies by 3.9 per cent in 2010 after a 2.2 per cent reduction in 2009. Rising profits and weak investment spending boosted deposit growth in the latter part of 2009 and the first half of 2010, but deposit growth has since weakened to 1.6 per cent over 2010 as a whole, after 4.5 per cent in 2009.

Low interest rates have, however, been a key benefit to consumers and businesses throughout 2010. Arrears and defaults rose by much less during the recession than in previous recessions, and began to improve in 2010 despite the weakness of the recovery in the economy. The number of company liquidations in England and Wales fell by nearly 16 per cent in 2010 after a 23 per cent rise in 2009, reducing the rate of failure of active companies to 0.7 per cent from 0.9 per cent in 2009. The number of individual insolvencies rose by a further 0.7 per cent in 2010 after a 26 per cent rise in 2009, but insolvencies during the second half of 2010 were 8.7 per cent lower than a year earlier. The number of mortgages in arrears across the market fell by 10 per cent in 2010, and the share in arrears by more than three months fell to its lowest in two years by Q4 2010.

The Group s customer data shows that a combination of low interest rates and declining indebtedness is beginning to strengthen households cashflow. This is positive news for both impairments and the near-term general economic outlook. Nevertheless, the Group expects that a continuation of weak economic recovery will be accompanied by a sustained period of weak growth in its markets. Consumers and businesses will continue to deleverage slowly. Deposit growth will be limited by the pressure on consumers disposable incomes from wage growth below inflation and cuts in welfare benefits, and from rising investment spend by companies. Arrears trends should continue to improve, but less quickly in the coming year than the experience through 2010.

In Ireland, the economy shrank by 1 per cent in 2010, the third year of decline in succession. The loan from the Eurozone Stability Fund is helping support the economy while the government implements its sharp fiscal consolidation, and is providing the funds to recapitalise the banking sector. Nevertheless, consumers are still adjusting to lower incomes and companies to reduced demand, and as a result property prices have fallen further during 2010 house prices by 10.8 per cent and commercial property prices by 10.7 per cent. The economy is expected to flatten out in 2011 but the environment remains challenging, particularly for property prices which are likely to fall further in the near-term before recovery begins.

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 consolidated financial statements.

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group s IFRS reporting are discussed in note 58 to the consolidated financial statements.

RESULTS OF OPERATIONS 2010, 2009 AND 2008

SUMMARY

	2010 £m	2009 £m	2008[1] £m
Net interest income	**12,546**	9,026	7,718
Other income	**30,921**	36,271	(709)
Total income	**43,467**	45,297	7,009
Insurance claims	**(18,511)**	(22,019)	2,859
Total income, net of insurance claims	**24,956**	23,278	9,868
Operating expenses	**(16,470)**	(15,984)	(6,100)
Trading surplus	**8,486**	7,294	3,768
Impairment	**(10,952)**	(16,673)	(3,012)
Share of results of joint ventures and associates	**(88)**	(752)	4
Gain on acquisition		11,173	
Loss on disposal of businesses	**(365)**		
(Loss) profit before tax	**(2,919)**	1,042	760
Taxation	**325**	1,911	38
(Loss) profit for the year	**(2,594)**	2,953	798
Profit attributable to non-controlling interests	**62**	126	26
(Loss) profit attributable to equity shareholders	**(2,656)**	2,827	772
(Loss) profit for the year	**(2,594)**	2,953	798

1 Restated in 2009 for IFRS 2 (Revised).

2010 COMPARED WITH 2009

The Group recorded a loss before tax of £2,919 million in 2010 compared to a profit of £1,042 million in 2009 as a result of the £3,200 million payment protection insurance provision (see page 32). The results in 2010 also included a pension curtailment gain of £910 million, largely offset by a customer goodwill payments provision of £500 million (see page 32) and a loss on disposal of businesses of £365 million. The profit in 2009 included a negative goodwill credit of £11,173 million in relation to the acquisition of HBOS plc by the Group and a fee of £2,500 million paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme. There were significant post-acquisition impairment losses in respect of the HBOS portfolios in both 2009 and 2010.

Total income decreased by £1,830 million, or 4 per cent, to £43,467 million in 2010 compared to £45,297 million in 2009; with a £3,520 million, or 39 per cent, increase in the Group s net interest income only partly offsetting a £5,350 million, or 15 per cent, decrease in other income.

Net interest income was £3,520 million, or 39 per cent, higher at £12,546 million in 2010 compared to £9,026 million in 2009. Net interest income was increased as the benefit of higher asset pricing more than offset the impact of lower deposit margins. The Group s net interest margin increased by 61 basis points to 1.67 per cent in 2010 compared to 1.06 per cent in 2009 with increases in both Retail, where margins improved as a result of improved asset pricing and decreases in the LIBOR to base rate spread, and in Wholesale, again as a result of higher asset pricing to reflect customer risk. There was, however, a reduced margin in Wealth and International as a result of lower base rates, a very competitive deposit environment and the impact of impaired lending balances.

Other income was £5,350 million, or 15 per cent, lower at £30,921 million in 2010 compared to £36,271 million in 2009. Fee and commission income was £161 million, or 4 per cent, higher at £4,415 million in 2010 compared to £4,254 million in 2009. Fee and commission expense was £165 million, or 11 per cent, higher at £1,682 million in 2010 compared to £1,517 million in 2009. Net trading income was £3,374 million lower at £15,724 million in 2010 compared to £19,098 million in 2009; this included a reduction of £2,551 million in gains on policyholder investments held in the Group s insurance businesses (although this was largely offset by a decrease in the related claims expense, see below) as a result of relative market conditions over 2010, compared to 2009; in addition, a loss of £620 million, which was £193 million, or 45 per cent, higher than the loss of £427 million in 2009, arose from the change in fair value of the embedded equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009. During 2010 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liabilities of £423 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs; this was £1,075 million, or 72 per cent, lower than the gains of £1,498 million realised on similar transactions in 2009.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance claims were £3,508 million lower at an expense of £18,511 million in 2010 compared to £22,019 million in 2009. The insurance claims expense in respect of life and pensions business was £3,413 million, or 16 per cent, lower at £17,972 million in 2010 compared to £21,385 million in 2009 as a result of the relative returns on policyholder investments in the long-term insurance business; this movement in claims was broadly matched by a decrease in net trading income reflecting the gains on those policyholder investments. Insurance claims in respect of general insurance business were £95 million, or 15 per cent, lower at £539 million in 2010 compared to £634 million in 2009, this was due primarily to lower payment protection insurance claims related to unemployment.

Operating expenses increased by £486 million, or 3 per cent, to £16,470 million in 2010 compared to £15,984 million in 2009, this increase principally reflects the £3,200 million payment protection insurance provision in 2010, more than offsetting the impact of the non-repetition of the £2,500 million fee paid to the UK Government in 2009 as part of the agreement for the Group not to enter into the Government Asset Protection Scheme. A pension curtailment gain of £910 million in 2010 was offset by a £557 million increase in integration costs and a £500 million customer goodwill payments provision. Staff costs were £1,206 million, or 18 per cent, lower at £5,469 million in 2010 compared to £6,675 million in 2009. Excluding the pension curtailment gain of £910 million in 2010, staff costs were £296 million, or 4 per cent, lower at £6,379 million in 2010 compared to £6,675 million in 2009, as decreased salary costs, reflecting head count reductions, and lower levels of staff restructuring costs were partly offset by increases in other staff costs (reflecting greater use of agency staff in relation to the integration programme). Premises and equipment costs were £69 million, or 6 per cent, higher at £1,225 million in 2010 compared to £1,156 million in 2009. Other expenses were £4,289 million higher at £7,142 million in 2010 compared to £2,853 million in 2009. This increase reflects the £3,200 million payment protection insurance provision and the £500 million customer goodwill payments provision, both in 2010, and increased communication costs, professional fees and other expenditure in relation to the ongoing integration of the Lloyds TSB and HBOS businesses. Depreciation and amortisation costs were £128 million lower at £2,432 million in 2010 compared to £2,560 million in 2009. In 2010 there was a charge of £202 million in respect of the impairment of tangible fixed assets; and in 2009 there was a charge of £240 million in respect of the impairment of goodwill attributable to the Group s asset finance business.

Impairment losses decreased by £5,721 million, or 34 per cent, to £10,952 million in 2010 compared to £16,673 million in 2009. Impairment losses in respect of loans and advances to customers were £5,056 million, or 32 per cent, lower at £10,727 million in 2010 compared to £15,783 million in 2009. This reflects improved credit experience in both the Retail and Wholesale divisions as a result of the improving economic environment in the UK and the US; partly offset by increased charges in the International business, especially in Ireland and Australia. The Group s through the cycle credit policies and procedures, which focus on the development of enduring client relationships, have resulted in higher quality new business being originated across the UK and very little new origination took place outside the UK. The Group s level of impairment is being managed in the current challenging economic environment by the Wholesale business support units and Retail collection and recovery units. The business support model has been expanded from Wholesale across Wealth and International division, with a central team established to manage the Group s business support activity globally. The Group has also strengthened resources within Retail collections and recoveries to enable more timely engagement with customers experiencing difficulties to drive more effective customer outcomes.

The Group s share of results of joint ventures and associates was a net loss of £88 million in 2010 compared to a net loss of £752 million in 2009; partly due to reduced losses in the joint venture vehicles and partly reflecting the fact that many of the investments are now substantially written-off.

On 16 January 2009, the Group acquired 100 per cent of the ordinary share capital of HBOS plc. As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill of £11,173 million arose on the acquisition. The negative goodwill was recognised as a Gain on acquisition in the income statement for the year ended 31 December 2009. There was no such credit in 2010.

In 2010, the Group incurred a loss on disposal of businesses of £365 million (2009: nil). During 2009, the Group had acquired an oil drilling rig construction business through a previous lending relationship and, in the second half of 2010, the Group reached agreement to dispose of its interests in the two wholly-owned subsidiary companies through which this business operates.

In 2010, the Group recorded a tax credit of £325 million compared to a tax credit of £1,911 million in 2009. The tax credit of £325 million in 2010 arose on a loss before tax of £2,919 million, an effective tax rate of 11 per cent compared to the standard UK corporation tax rate of 28 per cent. This lower rate reflects losses where no deferred tax is recognised together with the impact of the tax charge attributable to UK life insurance policyholders and the Group s interests in Open Ended Investment Companies (OEICs), which is required to be included within the income tax charge, and a charge resulting from the change in the UK corporation tax rate being largely offset by overseas tax rate differences and other adjustments.

Total assets were £34,817 million lower at £992,438 million at 31 December 2010 compared to £1,027,255 million at 31 December 2009; loans and advances to customers were £34,372 million, or 5 per cent, lower at £592,597 million at 31 December 2010 compared to £626,969 million at 31 December 2009; and customer deposits were £13,108 million, or 3 per cent, lower at £393,633 million at 31 December 2010 compared to £406,741 million at 31 December 2009; total assets have reduced as the Group has continued its strategy to reduce assets associated with non-relationship lending and investments, including business which is outside the Group s current risk appetite. During 2009, the Group had identified approximately £300 billion of such assets; and confirmed that it is the Group s intention to manage these assets for value and that, given the current economic climate, the primary focus would be on running these assets down over time. Over the next several years, the Group expects to achieve a reduction in these assets of approximately £200 billion (customer lending approximately £140 billion; treasury assets £60 billion). The reduction in total assets was substantially driven by reductions in non-core lending portfolios across the three banking divisions, continued customer deleveraging and de-risking and subdued demand in lending markets.

The Group s credit market exposures primarily relate to asset-backed security exposures held in the Wholesale division; on the balance sheet these exposures are classified as loans and receivables, available-for-sale or trading and other financial assets at fair value through profit or loss depending on the nature of the investment. A detailed analysis of these asset-backed security exposures is provided in note 56 to the consolidated financial statements. The Wholesale division s total exposure to asset-backed securities has decreased by £8,139 million from £42,863 million at 31 December 2009 to £34,724 million at 31 December 2010 as these investments continue to run-off.

Mortgage-backed security exposures were £2,562 million lower at £15,656 million at 31 December 2010 compared to £18,218 million at 31 December 2009. Exposures to Alt-A US residential mortgage-backed securities were £267 million lower at £3,700 million at 31 December 2010 compared to £3,967 million at 31 December 2009; there is no exposure to sub-prime US residential mortgage-backed securities.

For credit market exposures the Group s approach is to analyse the underlying transaction to determine whether it needs to place reliance on any protection provided by an insurer or guarantor. In note 56 to the consolidated financial statements the Group discloses its exposures where reliance is placed on monoline insurers, which are limited to a total of £254 million at 31 December 2010 (31 December 2009: £444 million); all of the exposure at 31 December 2010 is rated AA.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

At the end of December 2010, the Group s capital ratios increased with a total capital ratio on a Basel II basis of 14.5 per cent (compared to 12.4 per cent at 31 December 2009), a tier 1 ratio of 11.0 per cent (compared to 9.6 per cent at 31 December 2009) and a core tier 1 ratio of 9.6 per cent (compared to 8.1 per cent at 31 December 2009). During 2010, risk-weighted assets decreased by £86,935 million to £406,372 million at 31 December 2010 compared to £493,307 million at 31 December 2009; this decrease reflects balance sheet reductions across all banking divisions, a revised assessment of the Retail division s secured lending risk-weighted assets following improvements in the economic outlook and changes introduced as a result of continuing the process of integrating the Lloyds TSB and HBOS regulatory capital approaches which have impacted particularly on the Wholesale division.

2009 COMPARED WITH 2008

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

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

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

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

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

Operating expenses increased by £9,884 million, or 162 per cent, to £15,984 million in 2009 compared to £6,100 million in 2008. Excluding the operating expenses of £6,456 million arising on the consolidation of HBOS s post-acquisition results, operating expenses were £3,428 million, or 56 per cent, higher at £9,528 million in 2009 compared to £6,100 million in 2008; this increase principally reflected the £2,500 million fee paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme, costs of £635 million borne within the Lloyds TSB businesses in respect of the integration of the enlarged group and an increased charge in respect of goodwill impairment, only partly offset by the fact that operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments which was not repeated in 2009. Staff costs were £3,697 million, or 124 per cent, higher at £6,675 million compared to £2,978 million in 2008. Excluding the staff costs of £3,014 million that arose on consolidation of the post-acquisition results of HBOS, staff costs were £683 million, or 23 per cent, higher at £3,661 million in 2009 compared to £2,978 million in 2008, with particular increases in restructuring costs and other staff costs (reflecting increased use of agency staff in relation to the integration programme). Premises and equipment costs were £506 million, or 78 per cent, higher at £1,156 million in 2009 compared to £650 million in 2008. Excluding the premises and equipment costs that arose on the consolidation of the post-acquisition results of HBOS, premises and equipment costs were £84 million, or 13 per cent, higher at £734 million in 2009 compared to £650 million in 2008. Other expenses were £1,167 million, or 69 per cent, higher at £2,853 million in 2009 compared to £1,686 million in 2008. Excluding the £1,185 million of costs that arose on consolidation of the post-acquisition results of HBOS, other expenses were £18 million, or 1 per cent, lower at £1,668 million in 2009 compared to £1,686 million in 2008; however other expenses in 2008 included the £180 million settlement in relation to certain historic US dollar payments and, excluding this, other expenses excluding HBOS in 2009 were £162 million, or 11 per cent, higher at £1,668 million compared to £1,506 million in 2008. Depreciation and amortisation costs were £1,874 million higher at £2,560 million compared to £686 million in 2008; £1,813 million of this increase reflected the impact of consolidation of the post-acquisition results of HBOS. A charge of £240 million (2008: £100 million) arose in respect of the impairment of goodwill attributable to the Group s asset finance business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

The Group s share of results of joint ventures and associates was a net loss of £752 million in 2009 compared to a net profit of £4 million in 2008. However, excluding the losses of £755 million arising on the consolidation of HBOS s post-acquisition results, the share of results of joint ventures and associates was £1 million, or 25 per cent, lower at a profit of £3 million compared to a profit of £4 million in 2008.

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

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

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

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

Total assets were £591,222 million higher at £1,027,255 million at 31 December 2009 compared to £436,033 million at 31 December 2008; loans and advances to customers were £386,625 million higher at £626,969 million at 31 December 2009 compared to £240,344 million at 31 December 2008; and customer deposits were £235,803 million higher at £406,741 million at 31 December 2009 compared to £170,938 million at 31 December 2008. These increases reflected the impact of the HBOS acquisition and, after allowing for the acquisition, total assets had reduced as the Group commenced its announced strategy to reduce assets associated with non-relationship lending and investments, including business which was outside the Group s current risk appetite. During 2009, this portfolio of assets reduced by some £60 billion. Subsequent to the HBOS acquisition, the Group s loans and advances to customers decreased as a result of the alignment of heritage risk appetites in Retail, a reduction in wholesale lending in Corporate Markets and a reduction in Wealth and International; customer deposits also decreased as growth in Retail was offset by the planned reduction in higher interest paying term deposits elsewhere.

The Group s credit market exposures primarily relate to asset-backed security exposures held in the Wholesale division; a detailed analysis of these asset-backed security exposures is provided in note 56 to the consolidated financial statements. The total exposure to asset-backed securities had increased by £29,769 million from £16,521 million at 31 December 2008 to £46,290 million at 31 December 2009; however £31,010 million of these assets arose within the heritage HBOS business and, excluding these, total exposure to asset-backed securities was £1,241 million lower at £15,280 million at 31 December 2009 compared to £16,521 million at 31 December 2008.

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

For credit market exposures the Group s approach is to analyse the underlying transaction to determine whether it needs to place reliance on any protection provided by an insurer or guarantor. In note 56 to the consolidated financial statements the Group discloses its exposures where reliance is placed on monoline insurers, which were limited to a total of £444 million at 31 December 2009. Of this total exposure, £436 million was rated AA with the remaining £8 million being sub-investment grade.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2010	2009	2008
Net interest income £m	**12,546**	9,026	7,718
Average interest-earning assets £m	**753,415**	849,534	293,967
Average rates:			
Gross yield on interest-earning assets%	**3.89**	3.32	5.98
Interest spread%	**1.62**	1.02	2.37
Net interest margin%	**1.67**	1.06	2.63

1 Gross yield is the rate of interest earned on average interest-earning assets.

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

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

2010 COMPARED WITH 2009

Net interest income was £3,520 million, or 39 per cent, higher at £12,546 million in 2010 compared to £9,026 million in 2009. Interest and similar income was £1,102 million, or 4 per cent, higher at £29,340 million in 2010 compared to £28,238 million in 2009; and interest and similar expense was £2,418 million, or 13 per cent, lower at £16,794 million in 2010 compared to £19,212 million in 2009. In the Retail division, this reflects higher asset pricing (partly due to mortgage customers moving onto and staying on standard variable rates and lending being priced to more appropriately reflect risk and rising funding costs), in part offset by the impact on interest expense of lower LIBOR to base rate spreads although there has been a reduction in the more expensive deposit balances. In the Wholesale division, lending is also being re-priced to reflect customer risk profiles resulting in higher customer margins on new business and from re-pricing on renewals. Across the Group, there has been some increase in funding costs as a result of the Group s improved funding profile but there has been a benefit from a £723 million reduction in the amounts payable to unit holders in those Open-Ended Investment Companies included in the consolidated results of the Group (although, since these are policyholder items, there is no impact on profit attributable to shareholders).

Average interest-earning assets were £96,119 million, or 11 per cent, lower at £753,415 million in 2010 compared to £849,534 million in 2009. This reduction reflects the successful removal of assets which are outside of the Group s risk appetite from the Group s balance sheet.

Average interest-earning assets in Retail were £11,175 million, or 3 per cent, lower at £373,108 million in 2010 compared to £384,283 million in 2009. Average personal mortgage balances were £7,141 million, or 2 per cent, lower at £342,731 million in 2010 compared to £349,872 million in 2009, in part reflecting a slight reduction in demand in the UK mortgage market in 2010; Retail has continued to focus on supporting the housing market with 70 per cent of new lending being for house purchases rather than re-mortgages. Average other personal lending balances were £4,034 million, or 12 per cent, lower at £30,377 million in 2010 compared to £34,411 million in 2009 as a result of reduced customer demand for credit and customers continuing to reduce their personal indebtedness, with reductions in both unsecured loan and credit card balances.

Average interest-earning assets across the rest of the Group were £84,944 million, or 18 per cent, lower at £380,307 million in 2010 compared to £465,251 million in 2009. Relationship lending and similar average interest-earning assets in Wholesale were £25,040 million, or 11 per cent, lower at £196,040 million in 2010 compared to £221,080 million in 2009 as demand for new corporate lending and refinancing of existing facilities was more than offset by the level of maturities, reflecting a continuing trend of subdued corporate lending and customer deleveraging. Such balances in Wealth and International were £645 million, or 1 per cent, lower at £68,238 million in 2010 compared to £68,883 million in 2009. The remainder of the Group s average interest-earning assets, which include certain non-relationship and treasury-related balances in the Wholesale division and the bank deposits held in the insurance businesses, were £59,259 million, or 34 per cent, lower at £116,029 million in 2010 compared to £175,288 million in 2009; this reflects planned balance sheet reductions.

The Group s net interest margin increased by 61 basis points to 1.67 per cent in 2010 compared to 1.06 per cent in 2009 with increases in Retail and Wholesale only partly offset by reduced margins in the Wealth and International business. Margins in Retail improved as a result of improved asset pricing and decreases in the LIBOR to base rate spread. In Wholesale margins were also improved, again as result of higher asset pricing to reflect customer risk. Declining margins in Wealth and International reflected reduced base rates, a very competitive deposit environment and the impact of impaired lending balances.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2009 COMPARED WITH 2008

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER INCOME

	2010 £m	2009 £m	2008 £m
Fee and commission income:			
Current account fees	**1,086**	1,088	707
Credit and debit card fees	**812**	765	581
Other	**2,517**	2,401	1,943
	4,415	4,254	3,231
Fee and commission expense	**(1,682)**	(1,517)	(694)
Net fee and commission income	**2,733**	2,737	2,537
Net trading income	**15,724**	19,098	(9,186)
Insurance premium income	**8,148**	8,946	5,412
Gains on capital transactions	**423**	1,498	
Other	**3,893**	3,992	528
Other operating income	**4,316**	5,490	528
Total other income	**30,921**	36,271	(709)

2010 COMPARED WITH 2009

Other income was £5,350 million lower at £30,921 million in 2010 compared to £36,271 million in 2009, as a result of the factors discussed below.

Fee and commission income was £161 million, or 4 per cent, higher at £4,415 million in 2010 compared to £4,254 million in 2009. Current account fees were little changed at £1,086 million in 2010 compared to £1,088 million in 2009 but credit and debit card fees were £47 million, or 6 per cent, higher at £812 million in 2010 compared to £765 million in 2009. Other fee and commission income was £116 million, or 5 per cent, higher at £2,517 million in 2010 compared to £2,401 million in 2009.

Fee and commission expense was £165 million, or 11 per cent, higher at £1,682 million in 2010 compared to £1,517 million in 2009. There have been increases in fees payable related to added-value account packages and higher levels of card fees payable, as well as increased levels of fees payable in respect of the Group s fund management activities.

Net trading income was £3,374 million lower at £15,724 million in 2010 compared to £19,098 million in 2009. Net trading income within the insurance businesses was £2,551 million, or 16 per cent, lower at £13,749 million in 2010 compared to £16,300 million in 2009 reflecting a more subdued market performance in 2010 (equity market values increased by 9 per cent in 2010 compared to 22 per cent in 2009) although this decrease and the reduction in long-term insurance premium income are largely offset by the decrease in the insurance claims expense. A loss of £620 million, which was £193 million, or 45 per cent, higher than the loss of £427 million in 2009, arose from the change in fair value of the embedded equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009. Net trading income within the Group s banking activities was £630 million, or 20 per cent, lower at £2,595 million in 2010 compared to £3,225 million in 2009 as the Group continues to reduce activities outside of its risk appetite.

Insurance premium income was £798 million, or 9 per cent, lower at £8,148 million in 2010 compared to £8,946 million in 2009. Earned premiums in respect of the Group s long-term life and pensions business were £687 million, or 9 per cent lower at £6,773 million in 2010 compared to £7,460 million in 2009, this reflects reduced new business sales, mainly as a result of the withdrawal, during 2009, of certain HBOS legacy products with lower returns. General insurance earned premiums were £111 million lower at £1,375 million in 2010 compared to £1,486 million in 2009; this primarily reflects the Group s withdrawal from the payment protection insurance market in July 2010.

During 2009 and 2010, as part of the Group s management of capital, the Group exchanged certain existing subordinated debt securities for new subordinated debt securities and ordinary shares. These exchanges resulted in a gain on extinguishment of the existing liabilities of £423 million (2009: £1,498 million), being the difference between the carrying value of the securities extinguished and the fair value of the new securities issued together with related fees and costs. On 18 February 2010, as part of the Group s recapitalisation and exit from its proposed participation in the Government Asset Protection Scheme, Lloyds Banking Group plc issued 3,141 million ordinary shares in exchange for certain existing preference shares and preferred securities. This exchange resulted in a gain of £85 million. During March 2010 the Group entered into a bilateral exchange, under which certain Enhanced Capital Notes denominated in Japanese Yen were exchanged for an issue of new Enhanced Capital Notes denominated in US Dollars; the securities subject to the exchange were cancelled and a profit of £20 million arose. In addition, during May and

June 2010 the Group completed the exchange of a number of outstanding capital securities issued by Lloyds Banking Group plc and certain of its subsidiaries for ordinary shares in Lloyds Banking Group plc. The securities subject to exchange were cancelled, generating a total profit of £318 million for the Group.

Other operating income, excluding the gains on capital transactions, was £99 million lower at £3,893 million in 2010 compared to £3,992 million in 2009; increased gains on disposal of available-for-sale financial assets were more than offset by lower levels of operating lease rentals receivable and a reduction in the income arising from the movement in value of in-force business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2009 COMPARED WITH 2008

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

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

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

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

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

During 2009 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liabilities of £1,498 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs; this gain arose because the balance sheet carrying values of these investments were in excess of market valuations at the time. In the first half of 2009, undated subordinated notes issued by a number of Group companies were exchanged for innovative tier 1 securities and senior unsecured notes issued by Lloyds TSB Bank plc. These exchanges resulted in a gain of £745 million. In July 2009, dated and undated subordinated liabilities issued by Clerical Medical Finance plc were exchanged for senior unsecured notes issued by Lloyds TSB Bank plc resulting in a gain of £30 million. In November 2009, as part of the restructuring plan that was a requirement for EC approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group s preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. This suspension gave rise to a partial extinguishment of the original liability, equivalent to the present value of the suspended cash flows. During December 2009, as part of the Group s recapitalisation and exit from the Government Asset Protection Scheme, certain preference shares, preferred securities and undated subordinated notes were exchanged for enhanced capital notes. These exchanges, together with the partial extinguishment of liabilities arising from the suspension of payments on coupons, resulted in a gain of £723 million.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OPERATING EXPENSES

	2010 £m	2009 £m	2008[1] £m
Administrative expenses:			
Staff:			
Salaries	**4,220**	4,369	2,230
Social security costs	**396**	383	176
Pensions and other post-retirement benefit schemes:			
Curtailment gain	**(910)**		
Other	**628**	744	235
	(282)	744	235
Restructuring costs	**119**	412	14
Other staff costs	**1,016**	767	323
	5,469	6,675	2,978
Premises and equipment:			
Rent and rates	**601**	569	318
Hire of equipment	**18**	20	16
Repairs and maintenance	**199**	226	151
Other	**407**	341	165
	1,225	1,156	650
Other expenses:			
Communications and data processing	**891**	668	455
Advertising and promotion	**362**	335	194
Professional fees	**742**	540	229
Payment protection insurance provision	**3,200**		
Customer goodwill payments provision	**500**		
Other	**1,447**	1,310	808
	7,142	2,853	1,686
Depreciation and amortisation:			
Depreciation of tangible fixed assets	**1,635**	1,716	648
Amortisation of acquired value of in-force non-participating investment contracts	**76**	75	
Amortisation of other intangible assets	**721**	769	38
	2,432	2,560	686
Impairment of tangible fixed assets[2]	**202**		
Goodwill impairment		240	100
Total operating expenses, excluding Government Asset Protection Scheme fee	**16,470**	13,484	6,100
Government Asset Protection Scheme fee		2,500	
Total operating expenses	**16,470**	15,984	6,100
Cost:income ratio (%)[3]	**66.0**	68.7	61.8

1 Restated in 2009 for IFRS 2 (Revised).

2 £52 million of the impairment of tangible fixed assets relates to integration activities.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2010 COMPARED WITH 2009

Operating expenses increased by £486 million, or 3 per cent, to £16,470 million in 2010 compared to £15,984 million in 2009. This increase principally reflects the £3,200 million payment protection insurance provision in 2010, which more than offset the non-repetition of the £2,500 million fee paid in 2009 to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme.

Staff costs were £1,206 million, or 18 per cent, lower at £5,469 million in 2010 compared to £6,675 million in 2009. Staff costs in 2010 were reduced by a curtailment gain related to the Group s pension schemes. Following changes by the Group to the terms of its UK defined benefit pension schemes, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee s actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during 2010 there was also a change in commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group s defined benefit obligation of £1,081 million and a reduction in the Group s unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement. Excluding the pension curtailment gain of £910 million in 2010, staff costs were £296 million, or 4 per cent, lower at £6,379 million in 2010 compared to £6,675 million in 2009. Salaries were £149 million, or 3 per cent, lower at £4,220 million in 2010 compared to £4,369 million in 2009 as the impact of annual pay rises has been more than offset by staff reductions; pension costs, excluding the curtailment gain, were £116 million, or 16 per cent, lower at £628 million in 2010 compared to £744 million in 2009, principally as a result of increased asset levels in the defined benefit schemes at the end of 2009 which led to a higher expected return; staff restructuring costs were £293 million, or 71 per cent, lower at £119 million in 2010 compared to £412 million in 2009 principally as the significant staff rationalisations as part of the Group integration programme in 2009 were not repeated in 2010; and other staff costs were £249 million, or 32 per cent higher at £1,016 million in 2010 compared to £767 million in 2009, largely reflecting increased use of agency staff in relation to the integration programme.

Premises and equipment costs were £69 million, or 6 per cent, higher at £1,225 million in 2010 compared to £1,156 million in 2009. Rent and rates were £32 million, or 6 per cent, higher at £601 million in 2010 compared to £569 million in 2009, largely as a result of rent reviews; and other premises and equipment costs were £66 million, or 19 per cent, higher at £407 million in 2010 compared to £341 million in 2009 largely reflecting integration-related expenditure.

Other expenses were £4,289 million higher at £7,142 million in 2010 compared to £2,853 million in 2009. This increase principally reflects the £3,200 million payment protection insurance provision in 2010. On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial Review was heard in January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA s application. Since publication of the judgment, the Group has been in discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group has conducted of compliance with applicable sales standards which is continuing, the Group has concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group has made a provision in its income statement for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. Other expenses in 2010 also include a £500 million customer goodwill payments provision. Lloyds Banking Group has been in discussions with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the Halifax brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000.

Excluding the payment protection insurance provision and the customer goodwill payments provision, other expenses in 2010 were £589 million, or 21 per cent, higher at £3,442 million compared to £2,853 million in 2009. Communications and data processing costs were £223 million, or 33 per cent, higher at £891 million in 2010 compared to £668 million in 2009 and professional fees were £202 million, or 37 per cent, higher at £742 million in 2010 compared to £540 million in 2009; in both cases reflecting increased levels of integration-related expenditure.

Depreciation and amortisation costs were £128 million, or 5 per cent, lower at £2,432 million in 2010 compared to £2,560 million in 2009.

A charge of £202 million (2009: nil) arose in respect of the impairment of tangible fixed assets. During 2009, the Group had acquired an oil drilling rig construction business through a previous lending relationship and consolidated the results and net assets of the business from the date it exercised control; during 2010, as a result of a deteriorating market, the Group impaired the oil drilling rigs under construction held by the business by £150 million to reflect their reduced value in use. A further £52 million impairment charge related to the write-off of certain tangible fixed assets as a result of integration activities.

In 2009, a charge of £240 million had arisen in respect of the impairment of goodwill; there was no impairment charge in respect of goodwill in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2009 COMPARED WITH 2008

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

	2010	2009	2008
	£m	£m	£m
Impairment losses on loans and receivables:			
Loans and advances to banks	**(13)**	(3)	135
Loans and advances to customers	**10,727**	15,783	2,584
Debt securities classified as loans and receivables	**57**	248	157
Total impairment losses on loans and receivables	**10,771**	16,028	2,876
Impairment of available-for-sale financial assets	**106**	602	130
Other credit risk provisions	**75**	43	6
Total impairment charged to the income statement	**10,952**	16,673	3,012

2010 COMPARED WITH 2009

Impairment losses decreased by £5,721 million, or 34 per cent, to £10,952 million in 2010 compared to £16,673 million in 2009.

The reduction in the Group s impairment charge in 2010 reflected stabilisation of the wholesale portfolios and improved retail affordability and performance. Improvements in Wholesale and Retail more than offset increased impairment charges in Ireland and Australia, the latter caused by difficult market conditions. The Group s through the cycle credit policies and procedures, which focus on the development of enduring client relationships, have resulted in higher quality new business being originated across the UK and very little new origination took place outside the UK. The Group s level of impairment is being managed in the current challenging economic environment by the Wholesale business support units and Retail collection and recovery units. The business support model has been expanded from Wholesale across Wealth and International division, with a central team established to manage the Group s business support activity globally. The Group has also strengthened resources within Retail collections and recoveries to enable more timely engagement with customers experiencing difficulties to drive more effective customer outcomes. The Group has actively reduced limits to Portugal, Ireland, Italy, Greece and Spain over the last two years, with the associated country risk profile modest in the context of the Group s asset base.

The impairment charge in respect of loans and advances to customers was £5,056 million, or 32 per cent, lower at £10,727 million in 2010 compared to £15,783 million in 2009. This improvement reflects reduced impairment charges in both Retail, as a result of the improved quality of new business and a slow recovery in the UK economy, and Wholesale, where stabilising economic conditions have led to lower impairment charges, particularly in the corporate real estate and real estate-related UK and US portfolios; only partly offset by increased impairment charges in Wealth and International as a result of difficult market conditions in a number of locations abroad, particularly Ireland and Australia, and especially in relation to the commercial real estate portfolios in those locations. The level of losses continues to be dominated by the economic environment in Ireland, and to a lesser extent has also been influenced by the performance of specific areas of the Australian economy.

In Retail, there was a lower secured impairment charge reflecting reduced impaired loan levels and improved arrears in the first half of 2010, although in the second half, and particularly in the last quarter, the Group saw some signs of strain, with fewer customers returning their accounts to order than was the case six months previously. Although house prices fell slightly over 2010, the proportion of the mortgage portfolio with an indexed loan-to-value of greater than 100 per cent was broadly stable at 13 per cent. The value of the portfolio with an indexed loan-to-value greater than 100 per cent and more than three months in arrears increased by £0.2 billion and at 31 December 2010 was £3.2 billion, representing 0.9 per cent of the portfolio. The number of mortgage customers new to arrears has also remained relatively stable in the last twelve months, and is now well below the peak experienced in the second half of 2008. There was a decrease in the unsecured impairment charge, reflecting continued improving portfolio trends resulting from application of the Group s risk appetite, management actions taken over the past two years, and stable unemployment. Unsecured impaired loans decreased as a result of fewer cases going into arrears, improved quality of new business and increased write off of impaired loans.

The Wholesale impairment charge decreased as a result of the significant actions which were taken in the first half of 2009 on the heritage HBOS portfolios (including the identification of large impairments post the HBOS acquisition, especially in corporate real estate, real estate-related and Corporate (UK and US) portfolios), together with the stabilising UK and US economic environment in 2010, with a low interest rate environment helping to maintain defaults at a lower level and a number of write backs due to asset disposals.

The impairment charge in respect of loans and advances to banks improved by £10 million to a credit of £13 million compared to a credit of £3 million in 2009; this reflects releases in respect of a small number of specific exposures. The impairment charge in respect of debt securities classified as loans and receivables decreased by £191 million, or 77 per cent, to £57 million in 2010 compared to £248 million in 2009. Impairment losses in respect of available-for-sale financial assets were £496 million lower at £106 million in 2010 compared to £602 million in 2009. The charge in respect of other credit risk provisions was £32 million, or 74 per cent, higher at £75 million in 2010 compared to £43 million in 2009, as a result of a small number of specific new cases that arose in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2009 COMPARED WITH 2008

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

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

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

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

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

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

TAXATION

	2010 £m	2009 £m	2008 £m
UK corporation tax:			
Current tax on profits for the year	**(146)**	(227)	(667)
Adjustments in respect of prior years	**310**	(310)	(19)
	164	(537)	(686)
Double taxation relief	**1**	10	91
	165	(527)	(595)
Foreign tax:			
Current tax on profits for the year	**(82)**	(221)	(144)
Adjustments in respect of prior years	**49**	40	4
	(33)	(181)	(140)
Current tax credit (charge)	**132**	(708)	(735)
Deferred tax	**193**	2,619	773
Taxation credit	**325**	1,911	38

2010 COMPARED WITH 2009

The rate of tax is influenced by the geographic and business mix of profits. In 2010, a tax credit of £325 million arose on a loss before tax of £2,919 million and in 2009 a tax credit of £1,911 million arose on a profit before tax of £1,042 million. The statutory corporation tax rate was 28 per cent in both years. The Group s tax charge or credit is distorted, in particular, by the requirement to include, within income tax in the income statement, the tax attributable to UK life insurance policyholder earnings and the Group s interests in Open Ended Investment Companies, being a tax charge of £315 million for 2010 compared to a charge of £410 million in 2009. The tax position in 2009 was also particularly distorted by the gain on acquisition of £11,173 million, which did not attract a tax charge. In both 2010 and 2009, there was also an impact from tax losses, mostly in overseas jurisdictions, where deferred tax assets have not been recognised, leading to an additional charge of £487 million in 2010 (2009: £332 million). The remainder of the variation in effective tax rates reflects normal fluctuations in disallowed and non-taxable items. The Group does not expect the tax rate, excluding the impact of policyholders tax and Open Ended Investment Companies, to vary significantly from the average UK corporation tax rate.

2009 COMPARED WITH 2008

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

ECONOMIC PROFIT

In pursuit of its aim to maximise shareholder value over time, the Group has for a number of years used a system of value based management as a framework to identify and measure value creation and has used economic profit, a non-GAAP measure, as a measure of performance. The Group continues to believe that economic profit provides important information, because it captures both growth in investment and return and informs management decision making.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INTEGRATION

The Group remains on target to deliver annualised cost savings from synergies and other operating efficiencies of £2 billion by the end of 2011.

The sustainable run-rate synergies achieved as at 31 December 2010 totalled £1,379 million excluding a number of one-off savings. The table below analyses the run-rate synergies as at 31 December 2010 and the 2011 target run-rate of £2 billion by division.

		2010		2011
	Synergy run-rate as at 31 December 2010 £m	Allocation of Group Operations run-rate to divisions £m	Run-rate by market facing division £m	Target run-rate by market facing division £m
Retail	**301**	**228**	**529**	867
Wholesale	**248**	**111**	**359**	532
Wealth and International	**233**	**7**	**240**	242
Insurance	**167**	**30**	**197**	239
Group Operations	**393**	**(393)**		
Central items	**37**	**17**	**54**	120
Total	**1,379**		**1,379**	2,000

Savings to date continue to be driven largely from role reductions resulting from deployment of the new Group organisation design adopting the Lloyds TSB approach. The overwhelming majority of role reductions have been achieved through re-deployment, natural turnover and voluntary redundancy. In addition the Group has exited 79 non-branch properties during 2010, bringing the total to 162 since the start of the integration programme.

Procurement benefits in 2010 were also significant at £236 million and supplier negotiations resulted in over 90 per cent of Group expenditure being consolidated within our top 1,000 suppliers.

The software build of the Integrated IT Platform was completed in the first half of 2010 and, following extensive testing, largely implemented by the end of 2010 and is now live and operational for most Lloyds TSB processes and transactions. Roll out of the Lloyds TSB counter system across Halifax and Bank of Scotland branches commenced in late 2010 and will complete during the first half of 2011. Similarly HBOS ATMs are being migrated and the Group s target mortgage sales platform rolled out to mortgage sales advisers creating a single platform for mortgage sales.

Product and channel systems are being integrated and harmonised where required and this will continue through the first half of 2011 in parallel with a detailed and rigorous programme of testing in preparation for customer data migration from HBOS systems to the single IT platform by the end of 2011.

Integration activities have continued at pace over 2010 with delivery being wide ranging and spanning Group activities. Examples include the rollout of the Lloyds TSB model of day time cash deliveries to Halifax and Bank of Scotland branches; implementation of an improved online mortgage application process for mortgage brokers; delivery of a single scalable secure Internet Banking platform; launch of an integrated product proposition for our market leading Bancassurance business; migration of Asset Finance Lex customer and Bank of Scotland dealer finance books onto a single platform; and harmonisation of our loss notification and loss adjusting service processes for household insurance within our General Insurance business.

Total cost reductions from synergies of £1,361 million achieved in the year against the integration baseline and in line with target include other operating efficiencies and one-off savings which are excluded from the reported run rate synergies. The total cost reductions relate primarily to reductions in colleague numbers, procurement and IT savings.

Integration costs of £1,653 million were incurred in 2010 which have been excluded from the combined businesses results. This brings the total integration costs since the HBOS acquisition to £2,749 million. The integration costs relate to severance, IT and business costs of implementation. The severance provisions are for 26,000 role reductions announced to the end of 2010 of which 22,000 have been achieved to date.

27

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 combined businesses basis as explained below (see also note 4 to the consolidated financial statements).

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

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

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

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

- the 2008 results include the results of HBOS as if it had been acquired on 1 January 2008;
- the 2009 results assume HBOS had been owned throughout that year;
- the gain on acquisition of HBOS (in 2009) and amortisation of purchased intangible assets have been excluded; and
- the unwind of acquisition-related fair value adjustments is shown as one line in the 2010 and 2009 combined businesses income statements and has not been back-dated to 2008.

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

- the results of BankWest and St. Andrews, sold in December 2008, and the related loss on disposal; and the loss on disposal of businesses in 2010;
- integration costs;
- insurance and policyholder interests volatility;
- the Government Asset Protection Scheme (GAPS) fee paid in December 2009;
- goodwill impairment;
- the curtailment gain in 2010 in respect of the Group s defined benefit pension schemes;
- the payment protection insurance provision; and
- the customer goodwill payments provision.

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

The results of the businesses are set out below:

	2010	2009	2008
	£m	£m	£m
Retail	**4,716**	1,382	2,542
Wholesale	**3,257**	(4,703)	(10,479)
Wealth and International	**(4,824)**	(2,356)	277
Insurance	**1,102**	975	1,540
Group Operations and Central items:			
Group Operations	**(63)**	(149)	(76)
Central items	**(1,976)**	(1,449)	(517)
	(2,039)	(1,598)	(593)
Profit (loss) before tax combined businesses	**2,212**	(6,300)	(6,713)

The aggregate total of the combined businesses basis segmental results is a non-GAAP measure; further discussion of this measure is set out on page 47.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Note	**2010 £m**	2009 £m	2008 £m
Profit (loss) before tax combined businesses		**2,212**	(6,300)	(6,713)
Integration costs	1	**(1,653)**	(1,096)	
Volatility arising in insurance businesses	2	**306**	478	(2,349)
Government Asset Protection Scheme fee	3		(2,500)	
Negative goodwill credit	4		11,173	
Amortisation of purchased intangibles and goodwill impairment	5	**(629)**	(993)	(258)
Curtailment gain in respect of defined benefit pension schemes	6	**910**		
Pre-acquisition results of HBOS plc	7		280	10,825
Insurance grossing adjustment	8			10
Results of BankWest and St. Andrews	9			90
Payment protection insurance provision	10	**(3,200)**		
Customer goodwill payments provision	11	**(500)**		
Loss on disposal of businesses	12	**(365)**		(845)
(Loss) profit before tax statutory		**(2,919)**	1,042	760

1. Integration costs

Integration costs of £1,653 million were incurred in 2010 and £1,096 million in 2009; these relate to severance, IT and other costs of implementation. The severance provisions relate to some 26,000 role reductions announced by 31 December 2010, of which some 22,000 had been delivered by the end of 2010. The overwhelming majority of role reductions were achieved through re-deployment, natural turnover and voluntary redundancy.

2. Volatility arising in insurance businesses

The Group s statutory profit before tax is affected by insurance volatility, caused by movements in financial markets, and policyholder interests volatility, which primarily reflects the gross up of policyholder tax included in the Group tax charge.

During 2010, the Group s statutory profit before tax included positive insurance and policyholder interests volatility of £306 million compared to positive volatility of £478 million in 2009 and negative volatility of £2,349 million in 2008. The volatility in 2010 reflects the strong performance of equity markets, partly offset by lower than expected returns on cash and fixed interest assets; this compares to more significant improvements in financial markets in 2009. The negative volatility of £2,349 million in 2008 primarily reflects the far less favourable financial markets in that year.

Volatility comprises the following:

	2010 £m	2009 £m	2008 £m
Insurance volatility	**100**	237	(1,425)
Policyholder interests volatility	**216**	298	(924)
Insurance hedging arrangements	**(10)**	(57)	
Total	**306**	478	(2,349)

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

The most significant limitations associated with excluding volatility from the combined businesses results are:

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

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

Management compensates for the limitations above by:

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance volatility

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

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

United Kingdom (Sterling)	**2011**	**2010**	2009	2008
	%	**%**	%	%
Gilt yields (gross)	**3.99**	**4.45**	3.74	4.55
Equity returns (gross)	**6.99**	**7.45**	6.74	7.55
Dividend yield	**3.00**	**3.00**	3.00	3.00
Property return (gross)	**6.99**	**7.45**	6.74	7.55
Corporate bonds in unit-linked and with-profit funds (gross)	**4.59**	**5.05**	4.34	5.15
Fixed interest investments backing annuity liabilities (gross)	**4.78**	**5.30**	5.72	5.52

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

The liabilities in respect of the Group s annuity business are matched by a portfolio of fixed interest securities, which includes a large proportion of corporate bonds. In accordance with the approach adopted in previous years, the value of in-force business for the annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of these corporate bond holdings. The illiquidity premium is estimated to have remained at 75 basis points as at 31 December 2010 (31 December 2009: 75 basis points; 31 December 2008: 154 basis points). The insurance businesses experienced positive volatility of £100 million during 2010, compared to positive volatility of £237 million in 2009 and negative volatility of £1,425 million in 2008. The positive volatility of £100 million in 2010 was primarily driven by strong performance of equity and property investments relative to the expected return. During 2010, equity market values increased by 9 per cent and property returns reached 19 per cent. Partly offsetting this were lower than expected returns on cash and fixed interest assets. This benefit is lower than the £237 million positive volatility reported in 2009, as 2009 included significant benefits from reductions in corporate bond spreads, which did not occur in 2010, and greater out-performance of equity markets (during 2009, equities recovered by 22 per cent); these increases in 2009 being only partly offset by a reduction in gilts, reflecting an increase in yields and a reduction in property values of 6.6 per cent. The improvement in returns in 2009, however, was in contrast to the situation in 2008, when a 33 per cent reduction in equities was the main driver of the £1,425 million of negative volatility.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from the combined businesses results. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders over the long term.

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

During the year ended 31 December 2010, the statutory profit before tax included credits to other income of £216 million which related to the policyholder interests volatility tax charge (2009: credits of £298 million in other income which related to the policyholder interests volatility tax charge; 2008: charge of £924 million in other income which related to the policyholder interests volatility tax credit). Strong market conditions in the latter part of 2010 resulted in increased policyholder tax liabilities and led to a policyholder tax charge of £315 million (2009: charge of £410 million; 2008: credit of £461 million) for the year in the Group s tax charge. The market recovery in 2009 had increased policyholder tax liabilities and led to a policyholder tax charge during that year in the Group s tax charge; although this was partly offset by a credit relating to differences in the expected levels of policyholder tax provisions and charges. This compared to 2008 when substantial policyholder tax losses were generated as a result of the fall in property, bond and equity values.

Group hedging arrangements

The statutory results for the year ended 31 December 2010 also include a charge in relation to the Group s insurance hedging arrangements of £10 million (2009: £57 million; 2008: nil). To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of in-force business on the Group balance sheet, the Group purchased put option contracts in 2009. These expired in January 2010. The charge for these options in the year ended 31 December 2010 was £7 million (2009: £57 million). New protection against significant market falls, using option contracts, was acquired by the Group, financed by selling some upside potential from equity market movements. There was no initial cost associated with these hedging arrangements. On a mark-to-market valuation basis a loss of £3 million was recognised in relation to these new contracts in the year ended 31 December 2010. Subsequent to the year end, these 2010 option contracts were replaced by the Group in January 2011 with fresh contracts to provide further protection against significant market falls. Again this was financed, at no initial cost, by selling some upside potential from equity market movements.

3. Government Asset Protection Scheme fee

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

4. Negative goodwill credit

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

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

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

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

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

5. Amortisation of purchased intangibles and goodwill impairment

A total of £4,650 million of customer-related intangibles, brands, core deposit intangibles and purchased credit card relationships were recognised on the acquisition of HBOS in 2009 and these are being amortised over their estimated useful lives, where this has been determined to be finite. This has resulted in a charge of £629 million in the year ended 31 December 2010 (2009: £753 million).

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

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

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

6. Curtailment gain in respect of defined benefit pension schemes

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

7. Pre-acquisition results of HBOS plc

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

8. Insurance grossing adjustment

The Group s insurance businesses income statements include income and expenditure which are attributable to the policyholders of the Group s long-term assurance funds. These items have no impact upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the business, these items are shown net on a separate line.

9. Results of BankWest and St. Andrews

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

10. Payment protection insurance provision

On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial Review was heard in January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA s application. Since publication of the judgment, the Group has been in discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group has conducted of compliance with applicable sales standards, which is continuing, the Group has concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group has made a provision in its income statement for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses.

11. Customer goodwill payments provision

Lloyds Banking Group has been in discussions with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the Halifax brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Group made a provision of £500 million in relation to this programme during the year ended 31 December 2010.

12. Loss on disposal of businesses

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RETAIL

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

Retail is focused on effectively meeting the needs of its customers. The division has over 22 million current account customers and provides social banking to over four million people through basic banking or social banking accounts. It is also the largest provider of personal loans in the UK, as well as being the UK s leading credit card issuer. Retail provides over one in five new residential mortgages making it one of the leading UK mortgage lenders and provided over 50,000 mortgages to help first time buyers in 2010. Retail is the largest private sector savings provider in the UK. It is also a major general insurance and bancassurance distributor, offering a wide range of long-term savings, investment and general insurance products.

	2010 £m	2009 £m	2008 £m
Net interest income	**9,378**	7,970	8,454
Other income	**1,607**	1,804	2,739
Total income	**10,985**	9,774	11,193
Operating expenses	**(4,644)**	(4,566)	(4,963)
Trading surplus	**6,341**	5,208	6,230
Impairment	**(2,747)**	(4,227)	(3,695)
Share of results of joint ventures and associates	**17**	(6)	7
Profit before tax and fair value unwind	**3,611**	975	2,542
Fair value unwind	**1,105**	407	
Profit before tax	**4,716**	1,382	2,542

2010 COMPARED WITH 2009

Profit before tax from Retail was £3,334 million higher at £4,716 million compared to £1,382 million in 2009; profit in 2010 included £1,105 million in respect of the unwinding of the fair value adjustments arising on the acquisition of HBOS plc by the Group compared with £407 million in 2009.

Profit before tax and fair value unwind increased by £2,636 million to £3,611 million in 2010 compared to £975 million in 2009. This increase in profit was driven by higher income and a significant reduction in impairment losses, in the context of a stabilising economy, partly offset by an increase in operating expenses.

Total income increased by £1,211 million, or 12 per cent, to £10,985 million compared with £9,774 million in 2009 reflecting an increase in net interest income of £1,408 million, partially offset by a reduction in other income of £197 million.

Net interest income increased by 18 per cent. The net interest margin was 2.46 per cent compared with 1.97 per cent in 2009. The asset margins expanded in 2010 from 1.18 per cent to 1.93 per cent as a result of decreases in the LIBOR to base rate spread and stable customer interest rates. The asset margin also widened partly as a result of mortgage customers continuing to move onto, and staying on, standard variable rates and assets being priced to more appropriately reflect risk, offset by rising funding costs. The liability margin, on the other hand, has reduced from 1.41 per cent to 0.87 per cent as the effect of lower LIBOR to base rate spreads was partially offset by the reduction of expensive deposit balances.

Lending to customers in Retail, net of impairment provisions and fair value adjustments, was £7,327 million, or 2 per cent, lower at £363,731 million in 2010 compared with £371,058 million in 2009. This reflected reduced customer demand for credit and customers continuing to reduce their personal indebtedness.

Retail s gross new mortgage lending was £30,113 million in 2010 representing a market share of 22.1 per cent. New mortgage lending continued to be focused on supporting the housing market, with 70 per cent of the lending being for house purchase rather than re-mortgaging. Retail remains the largest lender to first time buyers in the market helping over 50,000 customers to buy their first home. It also continues to be an industry leader in its support for shared equity and shared ownership schemes. Average loan-to-value on new mortgage lending in 2010 was 60.9 per cent compared with 59.3 per cent in 2009, whilst average indexed loan-to-value on the mortgage portfolio was 55.6 per cent at 31 December 2010 compared with 54.8 per cent at 31 December 2009 and reflected the net fall in house prices in the year.

Total customer deposits were £11,442 million, or 5 per cent, higher at £235,591 million in 2010 compared with £224,149 million in 2009. The growth was predominantly from instant access and tax free cash ISA accounts, rather than more expensive term deposits. Retail continued to perform well in the savings market, with a strong stable of savings brands which can be tailored to customer demands.

Other income decreased by 11 per cent in 2010 to £1,607 million from £1,804 million in 2009 largely as a result of changes to current account overdraft charges. Retail continues to focus on having fees and rates that customers understand. It is believed that this will result in stronger customer relationships as well as supporting the deepening of these relationships. An example of this focus is the changes to the overdraft charging structure for Halifax and Bank of Scotland personal current accounts at the end of 2009, which delivers a more suitable product proposition and an improved customer experience and resulted in a reduction in other income of approximately £90 million. Similarly, the changes to the Lloyds TSB current account pricing model, which became effective at the end of 2010, provide a simpler, more sustainable proposition for customers, resulting in an overall reduction in the cost of overdraft usage.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Total income is analysed as follows and reflects the trends discussed above:

	2010 **£m**	2009 £m
Mortgages and Savings	**4,739**	3,667
Consumer Banking	**6,246**	6,107
Total income	**10,985**	9,774

Operating expenses increased by £78 million, or 2 per cent, to £4,644 million compared with £4,566 million in 2009. This was against a background of an increase in total income of 12 per cent and reflected ongoing cost control and synergies from the integration. The cost:income ratio for the year was 42.3 per cent compared to 46.7 per cent in 2009.

Impairment losses decreased by £1,480 million, or 35 per cent, to £2,747 million in 2010 compared with £4,227 million in 2009. Impairment losses as a percentage of average loans and advances to customers were 0.74 per cent in 2010 compared with 1.11 per cent in 2009. This reduction was driven primarily by the improved quality of new business and effective portfolio management, combined with the continued slow recovery of the economy. Across Retail in 2010, there were fewer cases going into arrears.

Unsecured impairment losses reduced by £983 million to £2,455 million compared with £3,438 million in 2009. This reflected a continuation of the improving portfolio trends resulting from the Group s prudent risk appetite, with a focus on lending towards existing customers, combined with stable unemployment. Secured impairment losses of £292 million, compared with £789 million in 2009, reflected a reduction in impaired loans and improved arrears in 2010, together with the stabilising economy, more stable house prices, low interest rates and prudent lending criteria.

Impaired loans in the unsecured portfolio decreased by £838 million to £2,981 million which represented 10.7 per cent of closing loans and advances to customers at 31 December 2010, compared with 11.9 per cent at 31 December 2009. The movement in impaired loans is consistent with the trends seen in both the flow of accounts to arrears and arrears balances, both of which have fallen across all unsecured products during 2010. This is a result of tightening credit policy across the credit lifecycle, including stronger controls on customer affordability, set against a stable economic environment. Retail s exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers changing financial circumstances. The portfolios results are supported by pre-recessionary levels of early arrears for accounts acquired in the last two years, highlighting an underlying improvement in the risk profile of the business. Impairment provisions decreased by £606 million, compared with 31 December 2009, to £1,507 million. Impairment provisions, as a percentage of impaired loans, decreased to 50.6 per cent at 31 December 2010 from 55.3 per cent at 31 December 2009, largely driven by more stringent criteria for new and existing unsecured collections repayment plans resulting in highly provided assets being written off.

Impaired loans in the secured portfolio decreased by £427 million to £6,769 million at 31 December 2010 and, as a percentage of closing loans and advances to customers, reduced to 2.0 per cent from 2.1 per cent at 31 December 2009. The reduction in impaired loans reflects the continued ability of customers to afford their mortgage payments in a low interest rate environment. The number of customers going into arrears remained stable throughout 2010. In the second half of 2010 fewer accounts in arrears returned to order resulting in higher early arrears balances for 31 December 2010 compared to 30 June 2010. As reported at the 2009 year end, Specialist lending remains closed to new business and this book is in run-off.

The fair value unwind was a net credit of £1,105 million compared with a net credit of £407 million in 2009. The net fair value unwind was larger in 2010 than in 2009 and reflected a smaller charge related to the fixed rate mortgage portfolios as mortgages reached the end of their fixed term and borrowers moved to standard variable products. This was partially offset by a reduction in the credit attributed to the fixed rate savings portfolio as fixed rate term deposits, existing prior to acquisition, matured.

2009 COMPARED WITH 2008

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WHOLESALE

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

Corporate Markets comprises Commercial, Corporate, Wholesale Markets, Wholesale Equity and Corporate Real Estate Business Support Unit. Commercial and Corporate provide relationship-based banking, risk management and advisory services to business customers, principally in the UK. Wholesale Markets provides risk management solutions, specialised lending, access to capital markets and multi-product financing solutions to its customers, whilst managing the Group s own portfolio of structured credit investments and treasury assets. Wholesale Equity manages the division s equity investment holdings (including Lloyds Development Capital). Corporate Real Estate Business Support Unit manages relationships with commercial real estate customers facing financial difficulties.

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

Asset Finance consists of a number of leasing and speciality lending businesses including Contract Hire (Lex Autolease and Hill Hire) and Consumer Finance (Black Horse Motor and Personal Finance).

	2010	2009	2008
	£m	£m	£m
Net interest income	**4,426**	4,710	5,752
Other income	**4,136**	4,199	(302)
Total income	**8,562**	8,909	5,450
Costs:			
Operating expenses	**(3,744)**	(4,106)	(4,591)
Impairment of tangible fixed assets	**(150)**		
	(3,894)	(4,106)	(4,591)
Trading surplus	**4,668**	4,803	859
Impairment	**(4,446)**	(15,683)	(10,394)
Share of results of joint ventures and associates	**(95)**	(720)	(944)
Profit (loss) before tax and fair value unwind	**127**	(11,600)	(10,479)
Fair value unwind	**3,130**	6,897	
Profit (loss) before tax	**3,257**	(4,703)	(10,479)

2010 COMPARED WITH 2009

Profit before tax from Wholesale improved by £7,960 million to a profit of £3,257 million compared to a loss of £4,703 million in 2009. The improvement of £7,960 million includes a credit of £3,130 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc, which were reduced by £3,767 million compared to £6,897 million in 2009.

Profit before tax and fair value unwind of £127 million improved by £11,727 million from a loss of £11,600 million in 2009. The improvement was driven by a decrease in the impairment charge, a decrease in the negative share of results of joint ventures and associates and a decrease in costs, only partially offset by lower income.

Total income decreased by £347 million, or 4 per cent, to £8,562 million in 2010 due to lower net interest income and other income.

Net interest income was £284 million, or 6 per cent, lower at £4,426 million in 2010 compared to £4,710 million in 2009. The decline in net interest income primarily reflects lower interest-earning asset balances in line with the Group s targeted balance sheet reduction, mainly in loans and advances to customers, debt securities and available-for-sale positions. Net interest income was affected by higher funding costs and lower lending volumes, partly offset by higher customer margins on new business and from re-pricing on renewals.

Banking net interest income, which excludes trading activity, increased by £330 million, to £3,683 million, as lending business continued to be re-priced to reflect customer risk profiles, with lending margins increasing by 26 basis points. Deposit margins increased moderately, by 13 basis points, reflecting favourable internal liquidity rates, which were partially offset by the impact of lower LIBOR to base rate spreads. As a result, the banking net interest margin increased by 36 basis points to 1.88 per cent in 2010. The impact of re-pricing was only partially offset by a decrease in average interest-earning assets and liability balances.

Other income was £63 million, or 2 per cent, lower at £4,136 million in 2010 compared to £4,199 million in 2009. This deterioration primarily reflects higher levels of market volatility in 2009 which resulted in mark-to-market gains in Wholesale Markets, whilst 2010 experienced losses on sale of assets in targeted balance sheet reductions and lower operating lease income. Other income in 2010, however, benefited from investment gains in Wholesale Equity as a result of stabilisation in market conditions and improved fund investment performance, strong fee income across structuring and capital markets and more favourable performance in Treasury and Trading.

Operating expenses decreased by £362 million, or 9 per cent, to £3,744 million in 2010 compared to £4,106 million in 2009. The decrease reflected reduced levels of operating lease depreciation and cost savings attributable to the integration programme. This was partially offset by additional costs in the Business Support Unit and continued investment in customer facing resources and systems.

The impairment charge decreased by £11,237 million to £4,446 million in December 2010 compared to £15,683 million in 2009. The impairment charge on loans and advances as a percentage of average loans and advances to customers improved to 2.08 per cent in 2010 compared to 5.92 per cent in 2009. The decrease reflects reductions, notably in the heritage HBOS corporate real estate and real estate-related portfolios and heritage HBOS Corporate (UK and US) portfolios, and write backs from asset disposals, due to the stabilising economic environment, low interest rates which helped to maintain defaults at reduced levels, the stabilisation of UK real estate prices and provisioning against base case assumptions undertaken on the acquired heritage HBOS portfolios in the first half of 2009.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The share of losses from joint ventures and associates comprises a small loss for the year of £95 million, a decrease of £625 million. This represents a net reduction in both the value and size of the portfolio compared to the prior year. The majority of the portfolio is now valued at nil with a remaining portfolio carrying value of approximately £128 million.

Wholesale s fair value unwind credit of £3,130 million decreased by £3,767 million in 2010 from £6,897 million in 2009 due to lower impairments in 2010 relating to the HBOS assets that were fair valued on acquisition, partially offset by charges relating to the expected losses on acquired debt securities and by fair value releases on sales.

2009 COMPARED WITH 2008

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

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

Lending to customers in Wholesale, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £42,754 million, or 18 per cent, lower at £191,808 million in 2009 compared to £234,562 million in 2008. Customer deposits were £4,552 million, or 3 per cent, lower at £153,389 million in 2009 compared to £157,941 million in 2008.

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

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

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

Impairment losses increased by £5,289 million to £15,683 million in 2009 compared to £10,394 million in 2008. Impairment losses on loans and advances as a percentage of average loans and advances to customers were 5.92 per cent in 2009 compared to 3.32 per cent in 2008. These increased impairment losses reflected the continued weak economic climate, higher levels of corporate failures, and application of the Lloyds Banking Group provisioning policy, notably in HBOS Corporate Real Estate and HBOS Corporate (UK and US) transactions.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WEALTH AND INTERNATIONAL

Wealth and International was formed in 2009 to give increased focus and momentum to the private banking and asset management businesses and to manage the Group s international businesses.

The Wealth business comprises private banking, wealth management and asset management. Wealth s global private banking and wealth management operations cater to the full range of wealth clients from affluent to Ultra High Net Worth within the UK, Channel Islands and Isle of Man, and internationally. The private banking and wealth management business operates under the Lloyds TSB and Bank of Scotland brands. The asset management business, Scottish Widows Investment Partnership, has a broad client base, managing assets for Lloyds Banking Group customers as well as a wide range of clients including pension funds, charities, local authorities, Discretionary Managers and Financial Advisers. In addition, the Group holds a 60 per cent stake in St James s Place, the UK s largest independent listed wealth manager and a 55 per cent stake in Invista Real Estate.

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

	2010 £m	2009 £m	2008 £m
Net interest income	**1,176**	1,217	1,314
Other income	**1,160**	1,128	1,191
Total Income	**2,336**	2,345	2,505
Operating expenses	**(1,536)**	(1,544)	(1,476)
Trading surplus	**800**	801	1,029
Impairment	**(5,988)**	(4,078)	(731)
Share of results of joint ventures and associates	**(8)**	(21)	(21)
(Loss) profit before tax and fair value unwind	**(5,196)**	(3,298)	277
Fair value unwind	**372**	942	
(Loss) profit before tax	**(4,824)**	(2,356)	277
Wealth	**269**	198	369
International	**(5,465)**	(3,496)	(92)
(Loss) profit before tax and fair value unwind	**(5,196)**	(3,298)	277

2010 COMPARED WITH 2009

The results of Wealth and International deteriorated by £2,468 million, or 105 per cent, to a loss before tax of £4,824 million in 2010 compared to a loss of £2,356 million in 2009.

Loss before tax and fair value unwind deteriorated by £1,898 million, or 58 per cent, to £5,196 million compared to a loss of £3,298 million in 2009, due, in particular, to a higher impairment charge, predominantly in Ireland. An improvement in profits in the Wealth business was more than offset by the increased losses in the International business.

Net interest income decreased by £41 million, or 3 per cent, to £1,176 million in 2010 compared to £1,217 million in 2009, as an 8 basis points decline in the banking net interest margin more than offset the favourable impact of foreign currency movements, particularly the Australian dollar, and the income on the £7 billion European loan portfolio transferred in from the Wholesale division in the second half of 2009.

Other income was £32 million, or 3 per cent, higher at £1,160 million in 2010 compared to £1,128 million in 2009. This increase reflects favourable foreign exchange movements and restrained growth in the Wealth business, despite lower asset management fee income following the sale of the external fund management business of Insight Investment in November 2009.

Operating expenses decreased by £8 million, or 1 per cent, to £1,536 million in 2010 compared to £1,544 million in 2009, with cost savings achieved from integration, particularly in the asset management businesses in Wealth, partly offset by investment in International s German deposit taking operation, increased risk management resources to manage impaired asset portfolios in Ireland and Australia and costs associated with the closure of the Irish business, and the effect of stronger foreign currency rates.

The impairment charge was £1,910 million, or 47 per cent, higher at £5,988 million in 2010, compared to £4,078 million in 2009, reflecting the material deterioration in the economic environment in Ireland in the last quarter of 2010 that resulted in EU-IMF financial support in late November 2010 and the tightening of liquidity in the second half of 2010 in regional Australian property markets to which the Group is exposed.

The impairment charge is summarised by key geography in the following table.

	2010 £m	2009 £m
Ireland	**4,264**	2,949
Australia	**1,362**	849
Wholesale Europe	**210**	129
Latin America/Middle East	**97**	69
Netherlands	**9**	11
International	**5,942**	4,007
Wealth	**46**	71
Wealth and International	**5,988**	4,078

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Loans and advances to customers decreased by £8,191 million, or 13 per cent, to £55,357 million at 31 December 2010 compared to £63,548 million at the end of 2009, reflecting net repayments of some £4.1 billion, and additional impairment provisions in the International businesses, partly offset by foreign exchange movements of some £1.1 billion.

Customer deposits increased by £3,747 million, or 13 per cent, to £32,784 million at 31 December 2010 compared to £29,037 million at the end of 2009, due to strong inflows in UK Private Banking and Bank of Scotland Germany, partly offset by outflows in Ireland following the closure of the Irish retail branch network.

2009 COMPARED WITH 2008

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE

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

LIFE, PENSIONS AND INVESTMENTS UK

The UK Life, Pensions and Investments business is the leading Bancassurance provider in the UK and has one of the largest intermediary channels in the industry. The business provides long-term savings, protection and investment products distributed through the Bancassurance, intermediary and direct channels using the Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows brands.

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

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

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

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

LIFE, PENSIONS AND INVESTMENTS EUROPE

The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands.

GENERAL INSURANCE

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

	2010 £m	2009 £m	2008 £m
Net interest income	**(263)**	(287)	(345)
Other income	**2,814**	2,944	3,493
Total income	**2,551**	2,657	3,148
Insurance claims	**(542)**	(637)	(481)
Total income, net of insurance claims	**2,009**	2,020	2,667
Operating expenses	**(854)**	(974)	(1,129)
Share of results of joint ventures and associates	**(10)**	(22)	2
Profit before tax and fair value unwind	**1,145**	1,024	1,540
Fair value unwind	**(43)**	(49)	
Profit before tax	**1,102**	975	1,540

Profit before tax and fair value unwind before impact of PPI new business closure	**1,215**	1,024	1,540
Other income impact of PPI new business closure	**(70)**		
Profit before tax and fair value unwind	**1,145**	1,024	1,540
Profit before tax and fair value unwind by business unit			
Life, Pensions and Investments:			
Before impact of PPI new business closure	**753**	617	826
PPI new business closure	**(70)**		
UK business	**683**	617	826
European business	**110**	75	149
General Insurance	**372**	367	537
Other	**(20)**	(35)	28
Profit before tax and fair value unwind	**1,145**	1,024	1,540

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2010 COMPARED WITH 2009

Profit before tax from Insurance was £127 million higher at £1,102 million compared to £975 million in 2009. Profit before tax and fair value unwind was £121 million higher at £1,145 million compared to £1,024 million in 2009.

Net interest income was £24 million, or 8 per cent, better at a deficit of £263 million in 2010 compared to a deficit of £287 million in 2009.

Other income decreased by £130 million, or 4 per cent, to £2,814 million in 2010 compared to £2,944 million in 2009 largely resulting from the decrease in PPI income as a result of the Group s decision to cease writing payment protection business, partially off-set by improved new business income and the higher than expected return from improved investment markets.

Total income, net of insurance claims decreased by £11 million, or 1 per cent, to £2,009 million in 2010 compared to £2,020 million in 2009, primarily reflecting lower PPI income and claims arising from the freeze events in 2010, which are offset by reduced payment protection insurance claims and improved investment markets.

Insurance claims were £95 million, 15 per cent, lower at £542 million in 2010 compared to £637 million in 2009 reflecting improved unemployment claims experience. The home book has been particularly affected by the freeze events experienced in January and December 2010. This has been partly offset by the benefits of ongoing claims processing improvements and integration.

Operating expenses decreased by £120 million, or 12 per cent, to £854 million in 2010 compared to £974 million in 2009 due to a continued focus on cost management and delivery of integration synergies.

2009 COMPARED WITH 2008

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LIFE, PENSIONS AND INVESTMENTS

UK BUSINESS

	2010 £m	2009 £m	2008 £m
Net interest income	**(227)**	(273)	(282)
Other income	**1,408**	1,474	1,758
Total income	**1,181**	1,201	1,476
Operating expenses	**(498)**	(584)	(650)
Profit before tax and fair value unwind	**683**	617	826
Profit before tax and fair value unwind before impact of PPI new business closure	**753**	617	826
Other income impact of PPI new business closure	**(70)**		
Profit before tax and fair value unwind	**683**	617	826
Profit before tax and fair value unwind analysis			
New business profit insurance business[1]	**332**	328	465
investment business[1]	**(65)**	(196)	(247)
Total new business profit	**267**	132	218
Existing business profit[2]	**464**	431	637
Experience and assumption changes	**22**	54	(29)
Profit before tax and fair value unwind before impact of PPI new business closure	**753**	617	826
Other income impact of PPI new business closure	**(70)**		
Profit before tax and fair value unwind	**683**	617	826

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

2 The disclosure of existing business profit has been changed to better reflect the performance of the business. Existing business profit includes the expected return on shareholder s net assets and experience and assumption changes are disclosed separately.

2010 COMPARED WITH 2009

Profit before tax and fair value unwind increased by £66 million, or 11 per cent, to £683 million in 2010 compared to £617 million in 2009. New business profit increased by £135 million, or 102 per cent, to £267 million. The increase primarily reflects a reduction in initial commission on OEICs sold through the branch network and cost reductions through integration across our sales channels in addition to progress made on product participation choices.

Existing business profit increased by £33 million, or 8 per cent, to £464 million in 2010 compared to £431 million in 2009. This predominantly reflects higher asset values and a higher assumed rate of return following improved market conditions in the second half of 2009.

Profits arising from experience and assumption changes decreased by £32 million to £22 million mainly reflecting the non-recurrence of benefits recognised in 2009, including a liability management gain of £30 million. During 2010 a review was undertaken into the charging between the funds of Clerical Medical prior to the acquisition of HBOS, giving rise to a charge of £132 million. Additionally assumptions regarding future maintenance expenses within the Clerical Medical business were aligned to reflect the heritage Lloyds TSB approach, giving rise to a charge of £119 million. These charges relate to pre-acquisition matters and were largely offset by the release of fair value provisions.

2009 COMPARED WITH 2008

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EUROPEAN BUSINESS

2010 COMPARED WITH 2009

Profit before tax and fair value unwind increased by £35 million, or 47 per cent, to £110 million in 2010 compared to £75 million in 2009 driven largely by experience and assumption changes. New business sales reflect difficult economic and market conditions in Germany, our main European market.

2009 COMPARED WITH 2008

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

NEW BUSINESS

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

	2010 UK £m	**2010 Europe £m**	**2010 Total £m**	2009 UK £m	2009 Europe £m	2009 Total £m	2008 UK £m	2008 Europe £m	2008 Total £m
Protection	**574**	**56**	**630**	519	49	568	492	51	543
Payment protection	**70**		**70**	153		153	679		679
Savings and investments	**1,617**	**315**	**1,932**	2,689	312	3,001	4,149	372	4,521
Individual pensions	**1,606**	**141**	**1,747**	2,275	185	2,460	4,216	306	4,522
Corporate and other pensions	**2,750**		**2,750**	2,600		2,600	2,940		2,940
Retirement income	**889**		**889**	887		887	1,451		1,451
Managed fund business	**177**		**177**	146		146	216		216
Life and pensions	**7,683**	**512**	**8,195**	9,269	546	9,815	14,143	729	14,872
OEICs	**2,633**		**2,633**	3,704		3,704	3,303		3,303
Total	**10,316**	**512**	**10,828**	12,973	546	13,519	17,446	729	18,175
Analysis by channel									
Bancassurance	**4,432**		**4,432**	6,997		6,997	8,356		8,356
Intermediary	**5,365**	**512**	**5,877**	5,639	546	6,185	8,704	729	9,433
Direct	**519**		**519**	337		337	386		386
Total	**10,316**	**512**	**10,828**	12,973	546	13,519	17,446	729	18,175

2010 COMPARED WITH 2009

The present value of new business premiums reduced by £2,691 million, or 20 per cent, to £10,828 million in 2010 compared to £13,519 million in 2009. This largely reflects the withdrawal in 2009 of certain HBOS legacy products with lower returns.

In the Bancassurance channel the reduction reflects the removal from sale of an HBOS guaranteed investment plan sold in 2009 and, since the integrated Bancassurance proposition was launched in June 2010, a change in mix away from savings products towards more profitable protection business in line with the legacy Lloyds TSB strategy. Sales of OEICs have been further adversely affected by a reduction in the volume of capital protected products given improved investment markets. However, sales of protection products have increased by 11 per cent and the aggregate new business margin has increased.

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

2009 COMPARED WITH 2008

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GENERAL INSURANCE

	2010 £m	2009 £m	2008 £m
Home insurance			
Underwriting income (net of reinsurance)	**922**	897	885
Commission receivable	**75**	71	50
Commission payable	**(135)**	(94)	(70)
	862	874	865
Payment protection insurance			
Underwriting income (net of reinsurance)	**544**	731	860
Commission receivable	**27**	13	428
Commission payable	**(318)**	(395)	(923)
	253	349	365
Other			
Underwriting income (net of reinsurance)	**6**	8	20
Commission receivable	**50**	69	71
Commission payable	**(15)**	(28)	(36)
Other (including investment income)	**(34)**	(6)	93
	7	43	148
Net operating income	**1,122**	1,266	1,378
Claims paid on insurance contracts (net of reinsurance)	**(542)**	(637)	(481)
Operating income, net of claims	**580**	629	897
Operating expenses	**(208)**	(262)	(360)
Profit before tax and fair value unwind	**372**	367	537

2010 COMPARED WITH 2009

Profit before tax and fair value unwind from General Insurance increased by £5 million, or 1 per cent, to £372 million in 2010 compared to £367 million in 2009, due primarily to improved unemployment claims experience plus integration synergies after taking account of lower income resulting from ceasing to write new PPI business and freeze related claims.

Underwriting income for home insurance showed modest growth of £25 million, or 3 per cent, to £922 million in 2010 compared to £897 million in 2009. Home commission payable was adversely affected by the alignment of commission arrangements between the legacy businesses during the year.

PPI underwriting income decreased by £187 million, or 26 per cent, to £544 million in 2010 compared to £731 million in 2009 reflecting the continued impact on new business volumes from the market wide move to monthly premiums in 2009 and the Group s withdrawal from the payment protection market on 23 July 2010. Changes in commission payable reflect lower volumes of PPI written during the year.

Claims were £95 million, or 15 per cent, lower at £542 million in 2010 compared to £637 million in 2009 reflecting lower unemployment claims experience. The home book has been particularly affected by the freeze events experienced in January and December 2010. This has been partly offset by the benefits of ongoing claims processing improvements and integration.

Operating expenses decreased by £54 million, or 21 per cent, to £208 million in 2010 compared to £262 million in 2009 primarily as a result of the alignment of commission arrangements on home insurance, the delivery of integration savings and a continued focus on cost management.

2009 COMPARED WITH 2008

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GROUP OPERATIONS

	2010	2009[1]	2008[1]
	£m	£m	£m
Net interest income	**(72)**	(69)	(59)
Other income	**49**	20	35
Total income	**(23)**	(49)	(24)
Direct costs:			
Information technology	**(1,209)**	(1,254)	(1,336)
Operations	**(628)**	(672)	(660)
Property	**(968)**	(983)	(1,021)
Procurement	**(56)**	(57)	(50)
Support functions	**(112)**	(116)	(104)
	(2,973)	(3,082)	(3,171)
Result before recharges to divisions	**(2,996)**	(3,131)	(3,195)
Total net recharges to divisions	**2,930**	2,957	3,115
Share of results of joint ventures and associates	**3**	3	4
Loss before tax and fair value unwind	**(63)**	(171)	(76)
Fair value unwind		22	
Loss before tax	**(63)**	(149)	(76)

1 2009 and 2008 comparative figures have been amended to reflect the impact of centralising operations across the Group as part of the integration programme. To ensure a fair comparison of 2010 performance, 2009 and 2008 direct costs have been increased with an equivalent offsetting increase in recharges to divisions.

2010 COMPARED WITH 2009

Loss before tax from Group Operations improved by £86 million to £63 million in 2010 compared to £149 million in 2009. The loss in 2009 included a credit of £22 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind improved by £108m to £63 million in 2010 compared to £171 million in 2009.

Total income, excluding recharges to divisions, improved by £26 million, to a deficit of £23 million in 2010 compared to a deficit of £49 million in 2009. Net interest income was £3 million, or 4 per cent, lower at a net expense of £72 million in 2010 compared to a net expense of £69 million in 2009. Other income was £29 million, or 145 per cent, higher at £49 million in 2010 compared to £20 million in 2009.

Direct costs were £109 million, or 4 per cent, lower at £2,973 million in 2010 compared to £3,082 million in 2009; this reflected the continued focus on cost management and the delivery of integration savings.

Information Technology costs decreased by 4 per cent primarily due to the further impact of integration benefits; Operations costs decreased by 7 per cent due to the continuing rationalisation of the major Operations functions and lower charges in respect of joint ventures; Group Property costs decreased by 2 per cent due to the continuing consolidation of the heritage property portfolios helping to deliver further integration benefits.

Recharges to divisions were £27 million, or 1 per cent, lower at £2,930 million in 2010 compared to £2,957 million in 2009.

2009 COMPARED WITH 2008

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

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

Direct costs were £89 million, or 3 per cent, lower at £3,082 million in 2009 compared to £3,171 million in 2008; this reflected the impact of integration savings and a continued focus on cost management.

Information Technology costs decreased by 6 per cent due to the early realisation of integration savings following the consolidation of IT operations across the Group in addition to lower investment spend as project activity was rationalised and replaced by integration activity; Group Property costs were also lower by 4 per cent which was primarily due to integration savings and the consolidation of premises (achieved at a faster rate than originally anticipated).

Recharges to divisions were £158 million, or 5 per cent, lower at £2,957 million in 2009 compared to £3,115 million in 2008.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CENTRAL ITEMS

	2010 £m	2009 £m	2008 £m
Net interest expense	**(823)**	(815)	(213)
Other income	**398**	1,780	(223)
Total income	**(425)**	965	(436)
Operating expenses	**(107)**	(294)	(21)
Trading (deficit) surplus	**(532)**	671	(457)
Impairment			(60)
Share of results of joint ventures and associates	**2**	(1)	
(Loss) profit before tax and fair value unwind	**(530)**	670	(517)
Fair value unwind	**(1,446)**	(2,119)	
Loss before tax	**(1,976)**	(1,449)	(517)

Central items are comprised of three main elements:

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

- interest on the Group s equity position;
- net interest margin cost resulting from central capital activities, primarily arising on the management of senior and subordinated debt and preference shares; and
- cost to the Group of funding wholesale and liquidity balances.

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

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

2010 COMPARED WITH 2009

Total income decreased by £1,390 million to £(425) million primarily due to a £1,045 million reduction in liability management gains, together with a £193 million increase in the mark-to-market losses arising from the equity conversion feature of the Group s Enhanced Capital Notes and a £131 million reduction in the gain on other derivatives which cannot be mitigated through hedge accounting.

Liability management gains arose on transactions undertaken in both 2009 and 2010 as part of the Group s management of capital which exchanged certain debt securities for ordinary shares or other debt instruments. These transactions resulted in a gain of £423 million in 2010 compared to a gain of £1,498 million in 2009 (of which £1,468 million is reflected in Central items). The fair value of the equity conversion feature of the Group s Enhanced Capital Notes decreased by £620 million in 2010 compared to a decrease of £427 million in 2009.

Net interest expense was broadly unchanged at £823 million, but included higher capital and wholesale liquidity funding costs of £601 million (2009: £260 million) not recovered from the divisions, with the increase primarily due to higher wholesale market funding spreads and the Group s decision to accelerate its wholesale funding in 2010. This has been offset by improved net interest from interest rate risk management activities compared to 2009.

Operating expenses reduced by £187 million to £107 million due to lower professional fees and other costs associated with capital transactions and projects.

Fair value unwind improved by £673 million to (£1,446) million primarily due to the effect of the liability management transactions leading to a reduced amortisation rate. Gains on liability management transactions included accelerated fair value amortisations.

2009 COMPARED WITH 2008

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMBINED BUSINESSES BASIS SUMMARY

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

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

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

Management uses the aggregated total of the combined businesses segmental results, a non-GAAP measure, as a measure of performance, and believes that it provides important information for investors, because it is a comparable representation of the Group s performance. Profit before tax is the comparable GAAP measure to profit before tax on a combined businesses basis; a reconciliation of the Group s statutory income statement to its combined businesses income statement is shown below. Readers should be aware that the combined businesses basis excludes certain items, as indicated in the tables below, reflected in the Group s statutory results and includes certain items, also indicated in the tables below, not reflected in the Group s statutory results. The Group refers readers to the discussion of its statutory results on pages 13 to 26.

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

		Removal of:					
2010	**Lloyds Banking Group statutory £m**	**Acquisition related items, including pension curtailment gain[1] £m**	**Volatility arising in insurance businesses £m**	**Insurance gross up £m**	**Payment protection insurance provision, customer goodwill payments provision and loss on disposal of businesses[2] £m**	**Fair value unwind £m**	**Combined businesses £m**
Net interest income	**12,546**		**26**	**949**		**301**	**13,822**
Other income	**30,921**		**(332)**	**(19,162)**		**(1,263)**	**10,164**
Total income	**43,467**		**(306)**	**(18,213)**		**(962)**	**23,986**
Insurance claims	**(18,511)**			**17,967**		**2**	**(542)**
Total income, net of insurance claims	**24,956**		**(306)**	**(246)**		**(960)**	**23,444**
Costs:							
Operating expenses	**(16,268)**	**1,320**		**246**	**3,700**	**74**	**(10,928)**
Impairment of tangible fixed assets	**(202)**	**52**					**(150)**
	(16,470)	**1,372**		**246**	**3,700**	**74**	**(11,078)**
Trading surplus (deficit)	**8,486**	**1,372**	**(306)**		**3,700**	**(886)**	**12,366**
Impairment	**(10,952)**					**(2,229)**	**(13,181)**
Share of results of joint ventures and associates	**(88)**					**(3)**	**(91)**
Loss of disposal of businesses	**(365)**				**365**		
Fair value unwind						**3,118**	**3,118**
(Loss) profit before tax	**(2,919)**	**1,372**	**(306)**		**4,065**		**2,212**

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

2 Comprises the payment protection insurance provision (£3,200 million), the customer goodwill payments provision (£500 million) and the loss on disposal of businesses (£365 million).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

Profit (loss) before tax	760	(10,825)	755	2,349	258	(10)	(6,713)

1 Restated in 2009 for IFRS 2 (Revised).

2010 COMPARED WITH 2009

Profit before tax on a combined businesses basis improved by £8,512 million to a profit of £2,212 million in 2010 compared to a loss of £6,300 million in 2009; however, the profit in 2010 included a credit of £3,118 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group whereas the loss in 2009 was after a fair value unwind credit of £6,100 million. Loss before tax and fair value unwind improved by £11,494 million to a loss of £906 million in 2010 compared to a loss of £12,400 million in 2009; this improvement was driven by lower impairment losses.

Total income decreased by £615 million, or 2 per cent, to £23,986 million in 2010 compared to £24,601 million in 2009.

Lending to customers, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group in 2009, was £34,372 million, or 5 per cent, lower at £592,597 million in 2010 compared to £626,969 million in 2009; customer deposits were £13,108 million, or 3 per cent, lower at £393,633 million in 2010 compared to £406,741 million in 2009. These balance sheet decreases reflected reductions in lending portfolios which are outside of the Group s appetite, continued customer deleveraging and de-risking and subdued demand in lending markets.

Net interest income was £1,096 million, or 9 per cent, higher at £13,822 million in 2010 compared to £12,726 million in 2009. The net interest margin, adjusted to exclude products where either the funding costs or the related revenues are recognised in other income, increased by 33 basis points to 2.10 per cent in 2010 compared to 1.77 per cent in 2009. Higher asset pricing and reduction in the average spread between base rate and LIBOR more than offset lower deposit margins and increasing wholesale funding spreads.

Other income was £1,711 million, or 14 per cent, lower at £10,164 million in 2010 compared to £11,875 million in 2009. This reduction primarily reflects a £1,075 million reduction in gains on capital transactions and a £193 million increase in the charge to income related to the fair value of the equity conversion feature of the Enhanced Capital Notes issued in 2009 as well as a reduction in payment protection insurance income and overdraft charges.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Costs decreased by £531 million, or 5 per cent, to £11,078 million in 2010 compared to £11,609 million in 2009. Savings related to the integration of the Lloyds TSB and HBOS business and lower levels of operating lease depreciation more than offset a charge of £150 million in respect of the impairment of tangible fixed assets.

Impairment losses decreased by £10,807 million, or 45 per cent, to £13,181 million in 2010 compared to £23,988 million in 2009. Impairment losses on loans and advances to customers as a percentage of average loans and advances to customers were 2.01 per cent in 2010 compared to 3.25 per cent in 2009. The decrease arose particularly in the Wholesale division, where a reduction of £11,237 million in the impairment charge reflects the actions which were taken in the first half of 2009 on the heritage HBOS portfolios (including the identification of large impairments post the HBOS acquisition, especially in the corporate real estate, real estate-related and Corporate (UK and US) portfolios), together with the stabilising UK and US economic environment in 2010, a low interest rate environment helping to maintain defaults at a lower level and a number of write backs due to asset disposals. The impairment charge within the Retail division was £1,480 million lower following improvements in impairment levels and arrears. In the Wealth and International division, however, impairment charges totalled £5,988 million, up 47 per cent on £4,078 million in 2009, reflecting increasing impairment charges in relation to corporate and real estate exposures in Ireland and Australia. The level of losses continues to be dominated by the economic environment in Ireland, and to a lesser extent has also been influenced by the performance of specific areas of the Australian economy.

The Group s share of results of joint ventures and associates improved by £676 million, or 88 per cent, to a loss of £91 million in 2010 compared to a loss of £767 million in 2009.

2009 COMPARED WITH 2008

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

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2010 Average balance £m	**2010 Interest income £m**	**2010 Yield %**	2009 Average balance £m	2009 Interest income £m	2009 Yield %	2008 Average balance £m	2008 Interest income £m	2008 Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	**70,808**	**512**	**0.72**	65,440	769	1.18	39,004	1,847	4.74
Loans and advances to customers	**594,361**	**25,459**	**4.28**	675,092	24,171	3.58	218,220	13,808	6.33
Debt securities	**31,248**	**1,377**	**4.41**	39,911	1,469	3.68	2,419	61	2.52
Lease and hire purchase receivables	**9,291**	**626**	**6.74**	14,165	852	6.01	9,266	706	7.62
Available-for-sale financial assets	**45,519**	**1,311**	**2.88**	54,926	977	1.78	25,058	1,147	4.58
Held-to-maturity investments	**2,188**	**55**	**2.51**						
Total interest-earning assets of banking book	**753,415**	**29,340**	**3.89**	849,534	28,238	3.32	293,967	17,569	5.98
Total interest-earning trading securities and other financial assets at fair value through profit or loss	**65,176**	**2,412**	**3.70**	59,849	2,224	3.72	24,292	1,577	6.49
Total interest-earning assets	**818,591**	**31,752**	**3.88**	909,383	30,462	3.35	318,259	19,146	6.02
Allowance for impairment losses on loans and advances	**(17,146)**			(9,551)			(2,838)		
Non-interest earning assets	**220,098**			164,056			60,939		
Total average assets and interest income	**1,021,543**	**31,752**	**3.11**	1,063,888	30,462	2.86	376,360	19,146	5.09

	2010 Average interest earning assets £m	**2010 Net interest income £m**	**2010 Net interest margin %**	2009 Average interest earning assets £m	2009 Net interest income £m	2009 Net interest margin %	2008 Average interest earning assets £m	2008 Net interest income £m	2008 Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	**753,415**	**12,546**	**1.67**	849,534	9,026	1.06	293,967	7,718	2.63
Trading securities and other financial assets at fair value through profit or loss	**65,176**	**2,172**	**3.33**	59,849	1,706	2.85	24,292	1,151	4.74
	818,591	**14,718**	**1.80**	909,383	10,732	1.18	318,259	8,869	2.79

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2010 Average balance £m	**2010 Interest expense £m**	**2010 Cost %**	2009 Average balance £m	2009 Interest expense £m	2009 Cost %	2008 Average balance £m	2008 Interest expense £m	2008 Cost %
Liabilities and shareholders funds									
Deposits by banks	**40,918**	**319**	**0.78**	93,234	883	0.95	42,150	1,540	3.65
Liabilities to banks under sale and repurchase agreements	**20,658**	**513**	**2.48**	42,794	1,399	3.27	5,643	253	4.48
Customer deposits	**355,670**	**5,381**	**1.51**	357,323	4,410	1.23	151,013	4,932	3.27
Liabilities to customers under sale and repurchase agreements	**42,530**	**231**	**0.54**	41,890	256	0.61	106	3	2.83
Debt securities in issue	**234,107**	**5,833**	**2.49**	247,079	6,318	2.56	54,359	2,227	4.10
Other interest-bearing liabilities	**12,882**	**898**	**6.97**	10,865	1,621	14.92	4,239		
Subordinated liabilities	**32,962**	**3,619**	**10.98**	43,033	4,325	10.05	15,400	896	5.82
Total interest-bearing liabilities of banking book	**739,727**	**16,794**	**2.27**	836,218	19,212	2.30	272,910	9,851	3.61
Total interest-bearing liabilities of trading book	**26,115**	**240**	**0.92**	28,639	518	1.81	11,769	426	3.62
Total interest-bearing liabilities	**765,842**	**17,034**	**2.22**	864,857	19,730	2.28	284,679	10,277	3.61
Interest-free liabilities									
Non-interest bearing customer accounts	**12,503**			6,902			3,793		
Other interest-free liabilities	**196,174**			158,881			76,584		
Minority interests and shareholders funds	**47,024**			33,248			11,304		
Total average liabilities and interest expense	**1,021,543**	**17,034**	**1.67**	1,063,888	19,730	1.85	376,360	10,277	2.73

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of average balances and interest for 2010 and 2009 between domestic and international offices is as follows:

	Domestic			Foreign			Total		
2010	**Average Balance £m**	**Interest income £m**	**Yield %**	**Average balance £m**	**Interest income £m**	**Yield %**	**Average balance £m**	**Interest income £m**	**Yield %**
Assets									
Loans and receivables:									
Loans and advances to banks	**55,288**	**408**	**0.74**	**15,520**	**104**	**0.67**	**70,808**	**512**	**0.72**
Loans and advances to customers	**538,329**	**23,433**	**4.35**	**56,032**	**2,026**	**3.62**	**594,361**	**25,459**	**4.28**
Debt securities	**29,662**	**1,359**	**4.58**	**1,586**	**18**	**1.13**	**31,248**	**1,377**	**4.41**
Lease and hire purchase receivables	**8,747**	**602**	**6.88**	**544**	**24**	**4.41**	**9,291**	**626**	**6.74**
Available-for-sale financial assets	**35,296**	**1,236**	**3.50**	**10,223**	**75**	**0.73**	**45,519**	**1,311**	**2.88**
Held-to-maturity investments	**2,188**	**55**	**2.51**				**2,188**	**55**	**2.51**
Total interest-earning assets of banking book	**669,510**	**27,093**	**4.05**	**83,905**	**2,247**	**2.68**	**753,415**	**29,340**	**3.89**
Total interest-earning trading securities and other financial assets at fair value through profit or loss	**59,472**	**2,208**	**3.71**	**5,704**	**204**	**3.58**	**65,176**	**2,412**	**3.70**
Total interest-earning assets	**728,982**	**29,301**	**4.02**	**89,609**	**2,451**	**2.74**	**818,591**	**31,752**	**3.88**
Allowance for impairment losses on loans and advances	**(13,171**)			**(3,975**)			**(17,146**)		
Non-interest earning assets	**215,606**			**4,492**			**220,098**		
Total average assets and interest income	**931,417**	**29,301**	**3.15**	**90,126**	**2,451**	**2.72**	**1,021,543**	**31,752**	**3.11**
Percentage of assets applicable to foreign activities (%)							**8.82**		

	Domestic			Foreign			Total		
	Average balance £m	**Interest expense £m**	**Cost %**	**Average balance £m**	**Interest expense £m**	**Cost %**	**Average balance £m**	**Interest expense £m**	**Cost %**
Liabilities and shareholders funds									
Deposits by banks	**24,041**	**219**	**0.91**	**16,877**	**100**	**0.59**	**40,918**	**319**	**0.78**
Liabilities to banks under sale and repurchase agreements	**14,933**	**419**	**2.81**	**5,725**	**94**	**1.64**	**20,658**	**513**	**2.48**
Customer deposits	**345,927**	**5,108**	**1.48**	**9,743**	**273**	**2.80**	**355,670**	**5,381**	**1.51**
Liabilities to customers under sale and repurchase agreements	**42,457**	**231**	**0.54**	**73**			**42,530**	**231**	**0.54**
Debt securities in issue	**204,200**	**5,214**	**2.55**	**29,907**	**619**	**2.07**	**234,107**	**5,833**	**2.49**
Other interest-bearing liabilities	**12,882**	**898**	**6.97**				**12,882**	**898**	**6.97**
Subordinated liabilities	**32,951**	**3,618**	**10.98**	**11**	**1**	**9.09**	**32,962**	**3,619**	**10.98**
Total interest-bearing liabilities of banking book	**677,391**	**15,707**	**2.32**	**62,336**	**1,087**	**1.74**	**739,727**	**16,794**	**2.27**
Total interest-bearing liabilities of trading book	**26,115**	**240**	**0.92**				**26,115**	**240**	**0.92**
Total interest-bearing liabilities	**703,506**	**15,947**	**2.27**	**62,336**	**1,087**	**1.74**	**765,842**	**17,034**	**2.22**
Interest-free liabilities	**11,563**			**940**			**12,503**		

Non-interest bearing customer accounts									
Other interest-free liabilities	**181,828**			**14,346**			**196,174**		
Minority interests and shareholders funds	**34,520**			**12,504**			**47,024**		
Total average liabilities and interest expense	**931,417**	**15,947**	**1.71**	**90,126**	**1,087**	**1.21**	**1,021,543**	**17,034**	**1.67**
Percentage of liabilities applicable to foreign activities (%)							**7.97**		

52

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	Domestic			Foreign			Total		
2009	Average Balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	57,500	594	1.03	7,940	175	2.20	65,440	769	1.18
Loans and advances to customers	619,856	22,092	3.56	55,236	2,079	3.76	675,092	24,171	3.58
Debt securities	38,189	1,439	3.77	1,722	30	1.74	39,911	1,469	3.68
Lease and hire purchase receivables	13,673	836	6.11	492	16	3.25	14,165	852	6.01
Available-for-sale financial assets	46,787	896	1.92	8,139	81	1.00	54,926	977	1.78
Total interest-earning assets of banking book	776,005	25,857	3.33	73,529	2,381	3.24	849,534	28,238	3.32
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,571	2,213	3.71	278	11	3.96	59,849	2,224	3.72
Total interest-earning assets	835,576	28,070	3.36	73,807	2,392	3.24	909,383	30,462	3.35
Allowance for impairment losses on loans and advances	(5,740)			(3,811)			(9,551)		
Non-interest earning assets	159,516			4,540			164,056		
Total average assets and interest income	989,352	28,070	2.84	74,536	2,392	3.21	1,063,888	30,462	2.86
Percentage of assets applicable to foreign activities (%)							7.01		

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

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

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 2010 compared with 2009 and for 2009 compared with 2008. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2010 compared with 2009 Increase/(decrease)			2009 compared with 2008 Increase/(decrease)		
	Total change £m	**Volume £m**	**Rate £m**	Total change £m	Volume £m	Rate £m
Interest receivable and similar income						
Loans and receivables:						
Loans and advances to banks	**(257)**	**39**	**(296)**	(1,078)	311	(1,389)
Loans and advances to customers	**1,288**	**(3,458)**	**4,746**	10,363	16,358	(5,995)
Debt securities	**(92)**	**(382)**	**290**	1,408	1,380	28
Lease and hire purchase receivables	**(226)**	**(328)**	**102**	146	295	(149)
Available-for-sale financial assets	**334**	**(271)**	**605**	(170)	531	(701)
Held-to-maturity investments	**55**	**55**				
Total banking book interest receivable and similar income	**1,102**	**(4,345)**	**5,447**	10,669	18,875	(8,206)
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	**188**	**197**	**(9)**	647	1,321	(674)
Total interest receivable and similar income	**1,290**	**(4,148)**	**5,438**	11,316	20,196	(8,880)
Interest payable						
Deposits by banks	**(564)**	**(408)**	**(156)**	(657)	484	(1,141)
Liabilities to banks under sale and repurchase agreements	**(886)**	**(550)**	**(336)**	1,146	1,215	(69)
Customer deposits	**971**	**(25)**	**996**	(522)	2,546	(3,068)
Liabilities to customers under sale and repurchase agreements	**(25)**	**3**	**(28)**	253	255	(2)
Debt securities in issue	**(485)**	**(323)**	**(162)**	4,091	4,928	(837)
Other interest bearing liabilities	**(723)**	**141**	**(864)**	1,621	989	632
Subordinated liabilities	**(706)**	**(1,106)**	**400**	3,429	2,777	652
Total banking book interest payable	**(2,418)**	**(2,268)**	**(150)**	9,361	13,194	(3,833)
Total interest payable on trading and other liabilities at fair value through profit or loss	**(278)**	**(23)**	**(255)**	92	305	(213)
Total interest payable	**(2,696)**	**(2,291)**	**(405)**	9,453	13,499	(4,046)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT

Pages 55 to 110 of the Operating and financial review and prospects contain both audited and unaudited information.

THE GROUP S APPROACH TO RISK (unaudited)

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

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

The Group uses an enterprise-wide risk management framework for the identification, assessment, measurement and management of risk. It seeks to maximise value for shareholders over time by aligning risk management with the corporate strategy, assessing the impact of emerging risks from legislation, new technologies or the market, and developing risk tolerances and mitigating strategies. The framework seeks to: strengthen the Group s ability to identify and assess risks, aggregate group-wide risks and define the corporate risk appetite, develop solutions for reducing or transferring risk, and where appropriate, exploit risks to gain competitive advantage, thereby seeking to increase shareholder value.

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

The Group Business Risk Committee and the Group Asset and Liability Committee are chaired by the Group Chief Executive and include all members of the Group Executive Committee. The aggregate group wide risk profile and portfolio appetite are discussed at these monthly meetings. The Risk Committee, chaired by a Non-Executive Director, comprises other Non-Executive Directors and oversees the Group s risk exposures. This Second-Line-Of-Defence Committee is supported by the Chief Risk Officer, who is independent of the front line business units, is a full member of the Group Executive Committee and reports to the Group Chief Executive. The Chief Risk Officer regularly informs the Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of the Risk Committee.

RISK AS A STRATEGIC DIFFERENTIATOR (unaudited)

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

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

As part of its integration initiative, the Group has rolled out the methodology and financial control framework that was used by the heritage Lloyds TSB Group; including compliance with the requirements of the US Sarbanes Oxley Act.

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

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

STATE FUNDING AND STATE AID (unaudited)

HM Treasury currently holds approximately 40.6 per cent of the Group s ordinary share capital. United Kingdom Financial Investments Limited (UKFI) as manager of HM Treasury s shareholding continues to operate in line with the framework document between UKFI and HM Treasury managing the investment in the Group on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group, although there have been no indications that the Government intends to change the existing operating arrangements.

The Group has made a number of undertakings to HM Treasury arising from the capital and funding support, including the provision of additional lending to certain mortgage and business sectors until 28 February 2011, and other matters relating to corporate governance and colleague remuneration. However the commitments in respect of lending are subject to normal prudent commercial lending criteria and pricing, the availability of funding to support such lending and the availability of sufficient demand from creditworthy customers and potential customers. The new agreement between the leading UK banks and the Government in relation to gross business lending in the 2011 calendar year is subject to a similar set of criteria.

In addition, the Group is subject to European state aid obligations in line with the restructuring plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Group and address any competition distortions arising from the benefits of state aid. This has placed a number of requirements on the Group including asset reductions in certain parts of its balance sheet by the end of 2014 and the disposal of certain portions of its business by the end of November 2013, including in particular the disposal of some

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

parts of its retail banking business. The Group is working closely with the EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission.

RISK GOVERNANCE

The embedding of an integrated governance and risk management framework throughout the Group has continued, through a consistent approach to risk appetite, policies, delegations and Risk Committee structures.

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

BOARD AND COMMITTEES (audited)

The Board, assisted by its key Risk Committees (Risk Committee and Audit Committee), approves the Group s overall risk management framework. The Board also reviews the Group s aggregate risk exposures and concentrations of risk to ensure that these are consistent with the Board s appetite for risk. The role of the Board, Audit Committee and Risk Committee are shown in the corporate governance section on pages 135 to 139, and further key risk oversight roles are described below.

In particular, the **Risk Committee**, (formerly Risk Oversight Committee) which comprises non-executive directors, oversees the development, implementation and maintenance of the Group s overall risk management framework and its risk appetite, strategy, principles and policies, to ensure that these are in line with emerging regulatory, corporate governance and industry best practice. The Risk Committee regularly reviews the Group s risk exposures across the primary risk drivers and the detailed risk types.

The **Group Executive Committee** assisted by the Group Business Risk Committee and the Group Asset and Liability Committee, supports the Group Chief Executive in ensuring the effectiveness of the Group s risk management framework and the clear articulation of the Group s risk policies, whilst also reviewing the Group s aggregate risk exposures and concentrations of risk.

The **Group Asset and Liability Committee** is responsible for the strategic management of the Group s assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility. The Group Asset and Liability Committee is supported by the **Senior Asset and Liability Committee**. This Senior Level Committee is responsible for the review of documentation relating to the management of assets and liabilities in the Group s balance sheet and the escalation of issues of group-level significance to the Group Asset and Liability Committee. It is also supported by the **Group Market Risk Forum** which escalates matters relating to the strategic management of the Group s structural market risks, including market risks held in the Group s insurance companies.

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

The Group Business Risk Committee is supported by the following Committees:

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

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

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

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

The **Group Financial Crime Committee** serves as the principal Group forum for reviewing and challenging the management of financial crime risk including the overall strategy and performance. 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.

The **Divisional Financial Control Committees,** which provide governance over financial statements. The meetings provide review and challenge as to the veracity of the results, press releases and supporting analyst information with oversight over the processes that have been followed in drawing them up. Items of focus are key assumptions and areas of subjectivity in the results and ensuring proper remediation of control issues that impact internal controls over financial reporting. The Group s auditors also report findings from their audit work.

The Group Risk Directors and Divisional Risk Officers meet on a regular basis under the Chairmanship of the Chief Risk Officer to review and challenge the risk profile of the Group and to ensure that mitigating actions are appropriate. Aggregate risk reports are reviewed by this group before submission to Group Business Risk Committees and then to Risk Committee.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK GOVERNANCE STRUCTURES (audited)

Group Executive Directors have primary responsibility for measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group s high level policies and within the parameters set by the Board, Group Executive Committee and Group Risk. Compliance with policies and parameters is overseen by the Risk Committee, the Group Business Risk Committee, the Group Asset and Liability Committee, Group Risk and the Divisional Risk Officers.

RISK MANAGEMENT OVERSIGHT (audited)

The Chief Risk Officer oversees and promotes the development and implementation of a consistent Group-wide risk management framework. The Chief Risk Officer, supported by the Group Risk Directors and the Divisional Risk Officers, provides objective challenge to the Group s senior management. The Group Executive Committee and the Board receive regular briefings and guidance from the Chief Risk Officer to ensure awareness of the overarching risk management framework and a clear understanding of their accountabilities for risk and internal control.

Group Risk Directors who report directly to the Chief Risk Officer, are allocated responsibility for specific risk types and are responsible for ensuring the adequacy of the framework for their risk types as well as the oversight of the risk profile across the Group. Divisional Risk Officers have dual reporting lines to their own divisional executive and also to the Chief Risk Officer and are responsible for the risk profile within their own divisions. This matrix approach enables the Group Executive Committee members to fulfil their risk management accountabilities.

Divisional Risk Officers provide oversight of risk management activity for all risks within each of the Group s divisions. Reporting directly to the Group Executive Directors responsible for the divisions and to the Chief Risk Officer, their day-to-day contact with business management, business operations and risk initiatives provides an effective risk oversight mechanism.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT FRAMEWORK (audited)

RISK MANAGEMENT IN THE BUSINESS (audited)

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

All business units, divisions and group functions complete a control self assessment annually (see page 139), reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Managing directors of each business and each Group Executive Committee member certify the accuracy of their assessment.

Risk management in the business forms part of a tiered risk management model, as shown above, with the Divisional Risk Officers and Group Risk providing oversight and challenge, as described above, and the Chief Risk Officer and group committees establishing the group-wide perspective.

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

RISK MANAGEMENT FRAMEWORK (audited)

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

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

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

The Lloyds Banking Group business strategy and objectives are used to determine the Group s high level risk principles and risk appetite measures and metrics for the primary risk drivers (see the table entitled Risk drivers). The risk appetite is proposed by the Group Chief Executive and reviewed by various governance bodies including the Group Executive Committee and the Risk Committee. Responsibility for the approval of risk appetite rests with the Board. The approved high level appetite and limits are delegated to individual Group Executive Committee members by the Group Chief Executive.

The more detailed description of the risk principles and distribution of the risk appetite measures amongst the divisions and businesses are determined by the Group Chief Executive, in consultation with the Group Business Risk Committee and the Group Asset and Liability Committee.

The risk principles are executed through the **Policy Framework and Accountabilities.** These principles are supported by the policy levels below:

Principles high level principles for the six primary risk drivers

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

Detailed group policy detailed policy that applies across the Group

Divisional policy local policy that specifically applies to a division

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

Execution of the Group s risk management framework is dependent upon a clear and consistent **risk identification** using a common language to define risks and to categorise them (see the table entitled Risk drivers).

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

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

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

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

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

At group level, a consolidated risk report is produced which is reviewed and debated by the Group Business Risk Committee, Group Executive Committee, Risk Committee and the Board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The consolidated risk report provides a quarterly assessment of the aggregate residual risk for the primary risk drivers, comparing the assessment with the previous quarter and providing a forecast for the next six months.

PRINCIPAL RISKS AND UNCERTAINTIES (audited)

At present the most significant risks faced by the Group, which are derived from the primary risk drivers detailed in the table entitled Risk drivers, are:

Risk: Definition	Features
Credit: The risk of reductions in earnings and/or value, through financial loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).	Arising in the Retail, Wholesale and Wealth and International divisions, reflecting the risks inherent in the Group s lending activities and, to a much lesser extent in the Insurance division in respect of investment of own funds. Adverse changes in the credit quality of the Group s UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group s assets and materially increase the Group s write-downs and allowances for impairment losses. Credit risk can be affected by a range of factors, including, inter alia, increased unemployment, reduced asset values, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates or higher tenant defaults. Over the last three years, the global banking crisis and economic downturn has driven cyclically high bad debt charges. These have arisen from the Group s lending to: Wholesale customers (including those in Wealth and International): where companies continue to face difficult business conditions, resulting in elevated corporate default levels, illiquid

commercial property markets and heightened impairment charges. The Group has high levels of exposure in both the UK and internationally, including Ireland, USA and Australia. There are particular concentrations to financial institutions and commercial real estate, including secondary and tertiary locations.

Retail customers (including those in Wealth and International). UK bad debts have reduced materially in 2010 as a result of risk management activity and more stable, low interest rate UK economic conditions. This portfolio will remain strongly linked to the economic environment, with inter alia house prices fall, unemployment increases, consumer over-indebtedness and rising interest rates all likely to impact both secured and unsecured retail exposures.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk: Definition	Features
Legal and regulatory: Legal and regulatory risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from failing to comply with the laws, regulations or codes applicable.	Legal and regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector. The Group continues to face political and regulatory scrutiny as a result of the Group s perceived systemic importance following the acquisition of HBOS. At the time of the acquisition, the Office of Fair Trading (OFT) identified some competition concerns in the UK personal current accounts and mortgages markets and for SME banking in Scotland. The OFT reiterated that it would keep these under review and consider whether to refer any banking markets to the Competition Commission if it identifies any prevention, restriction or distortion of competition. The UK Government appointed an Independent Commission on Banking to review possible structural measures to reform the banking system and promote stability and competition. That commission will publish its final report by the end of September 2011. The Treasury Select Committee is conducting an examination of competition in retail banking. It is too early to quantify the potential impact of these developments on the Group. From April 2011, lead regulation and supervision of the Group s activities will begin transitioning from the FSA to the new Financial Conduct Authority for conduct of business supervision and the Prudential Regulatory Authority for capital and liquidity supervision. In addition, from 2011, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory approaches across the EU. These could lead to changes in how the Group is regulated and supervised on a day-to-day basis. Evolving capital and liquidity requirements continue to be a priority for the Group. In September 2010 and further clarified in December 2010, the Basel Committee on Banking Supervision put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of capital , introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2012 and 2018. The Group is currently assessing the impacts of these regulatory developments and will participate in the consultation and calibration processes to be undertaken by the various regulatory bodies during 2011. The insurance division is progressing its plans to achieve Solvency II compliance. The Group continues to work closely with the regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes and mitigate against risks to the Group and its stakeholders. There is a risk that certain aspects of the Group s business may be determined by the authorities or the courts as not being conducted in accordance with applicable laws or regulations, or with what is fair and reasonable in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.
Liquidity and funding: Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Funding risk is defined as the	Arising in the banking business of the Group through the Retail, Wholesale and Wealth and International divisions reflecting the risk that the Group is unable to attract and retain either retail, wholesale or corporate deposits or issue debt securities. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and provide liquidity when necessary, the Group s ability to fund its financial obligations could be impacted.

risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.	The key dependencies for successfully funding the Group s balance sheet include the continued functioning of the money and capital markets; successful right sizing of the Group s balance sheet; the continuation of HM Treasury and Bank of England facilities in accordance with the terms agreed; limited further deterioration in the UK s and the Group s credit rating and no significant or sudden withdrawal of deposits resulting in increased reliance on wholesale funding markets. A return to the extreme market conditions of 2008 would place a strain on the Group s ability to meet its financial commitments. Liquidity and funding risks are managed within a Board approved framework using a range of metrics to monitor the Group s profile against its stated appetite and potential market conditions.

Risk: Definition	Features
Market Risk: The risk of reductions in earnings and/or value, through financial or reputational loss, from unfavourable market moves; including changes in, and increased volatility of, interest rates, market-implied inflation rates, credit spreads, foreign exchange rates, equity, property and commodity prices.	Market risk is managed within a Board approved framework using a range of metrics to monitor the Group s profile against its stated appetite and potential market conditions. The principal market risks are as follows: There is a risk to the Group s banking income arising from the level of interest rates and the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates. The main equity market risks arise in the life assurance companies and staff pension schemes. Credit spread risk arises in the life assurance companies, pension schemes and banking businesses. Equity market movements and changes in credit spreads impact the Group s results. Continuing concerns about the scale of deficits in Ireland and southern European countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the Euro and widened spreads between central bank and interbank rates. The Group s trading activity is small relative to its peers and is not considered to be a principal risk. The average 95 per cent 1-day trading Value at Risk (VaR) was £7.4 million for 2010.
Insurance Risk: The risk of reductions in earnings and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/ underwritten events and to fluctuations in the timing and amount of claims settlements.	The major sources of insurance risk are within the insurance businesses and the staff defined benefit pension schemes. Insurance risk is inherent in the insurance business and can be affected by customer behaviour. Insurance risks accepted relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment. The primary insurance risk carried by the Group s defined benefit pension schemes is related to longevity. Insurance risks typically, and longevity in particular, crystallise gradually over time. Actuarial assumption setting for financial reporting and liability management requires expert judgement as to when evidence of an emerging trend is sufficient to require an alteration to long-run assumptions.
Customer treatment: The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment.	Customer treatment and how the Group manages its customer relationships affects all aspects of the Group s operations and is closely aligned with achievement of the Group s strategic aim to create deep long lasting relationships with its customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies. The FSA continues to drive focus on conduct of business activities and has established a new approach to supervision of Conduct Risk, replacing the previous Treating Customers Fairly initiative for retail customers. Under this new regime the FSA has indicated that it will seek to place greater emphasis on product governance and contract terms in general, and will seek to intervene much earlier in the product lifecycle to prevent customer detriment. The FSA also continues to carry out thematic reviews on a variety of issues across the industry as a whole, for example complaints handling. The Group actively engages with the regulatory authorities and other stakeholders on these key customer treatment challenges, which includes for example, PPI (see note 54 to the financial statements Contingent liabilities and commitments). The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers. Since the acquisition of HBOS, the Group has made significant progress in aligning its approach to Treating Customers Fairly across both heritages. In addition the Group

has aligned its Treating Customers Fairly governance and management information arrangements, with customer impact being a key factor in assessing every integration proposition. The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place.

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

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

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

The Group s remuneration arrangements encourage compliant and appropriate behaviour from colleagues, in line with group policies, values and short and long term people risk priorities. The Group has continued to work closely with regulators, to seek to ensure compliance with our obligations. However, there is recognition that international consensus must be achieved to avoid UK institutions being significantly disadvantaged in attracting and retaining the highest calibre talent.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk: Definition	Features
Integration: The risk that Lloyds Banking Group fails to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or incurs unanticipated costs and losses associated with, the acquisition of HBOS plc.	The integration of the two heritage organisations continues to be one of the largest integration challenges that has been seen in the UK financial services industry. The Group s Integration Execution Board, chaired by the Group Operations Director, continues to oversee the integration process and progress is being regularly reviewed by the Group Executive Committee and Group Board. While there continue to be delivery risks to the programme, not least the risk of new regulatory requirements which may have an effect on resourcing, the Group is now two years into the integration programme and has a fully developed and functioning governance framework to manage these risks. There is a clear understanding of the phased deliverables to ensure effective delivery through to 2012.

RISK DRIVERS (unaudited)

RISK DRIVERS (unaudited)

The Group s risk language is designed to capture the Group s primary risk drivers . A description of each primary risk driver , including definition, appetite, control and exposures, is included below. These are further sub divided into 31 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out in the table above.

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

BUSINESS RISK (unaudited)

DEFINITION

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

RISK APPETITE

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

EXPOSURES

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

- internal factors: resource capability and availability, customer treatment, service level agreements, products and funding and the risk appetite of other risk categories; and
- external factors: economic, technological, political, social and ethical, environmental, legal and regulatory, market expectations, reputation and competitive behaviour.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MEASUREMENT

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

MITIGATION

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

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

MONITORING

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

CREDIT RISK

DEFINITION (audited)

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

RISK APPETITE (audited)

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

This statement of the Group s overall appetite for credit risk is reviewed and approved annually by the Board. With the support of the Group Credit Risk Committee and Group Business Risk Committee, the Group Chief Executive allocates this risk appetite across the Group. Individual members of the Group Executive Committee ensure that credit risk appetite is further delegated to an appropriate level within their areas of responsibility.

EXPOSURES (audited)

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients. The credit risk exposures of the Group are set out in note 56 to the financial statements. Credit risk exposures are categorised as retail arising in the Retail and Wealth and International Divisions and wholesale arising in the Wholesale and Wealth and International Divisions.

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

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 19 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2010. The notional principal amount does not, however, represent the Group s credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 56.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MEASUREMENT (audited)

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

The Group s rating systems assess probability of default and if Advanced, exposure at default and loss given default, in order to derive an expected loss. (If not Advanced, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss). In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment (see note 2(H) to the financial statements). Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

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

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale.

(Note 56 to the financial statements provides an analysis of the portfolio and pages 68 to 78 provide details of the Group s Credit risk portfolio.)

MITIGATION (audited)

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

INTERNAL CONTROL

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

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

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

Credit scoring: In its principal retail portfolios, the Group uses statistically based decisioning techniques (primarily credit scoring models). Divisional risk departments review model effectiveness, while new models and model changes are referred by them to divisional model governance committees for approval. The most material changes are referred to the Group Model Governance Committee.

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

Controls over rating systems: The Group has established an independent team in Group Risk 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 by risk functions either in the business units or divisions, with the business unit managing directors having ownership of the systems. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions in their respective division.

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

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group s risk appetite and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 21 to the financial statements provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group s large exposures are reported in accordance with regulatory reporting requirements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

Risk assurance and oversight: Divisional and group level oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Group credit risk assurance, a group level function comprising forty seven experienced credit professionals, is also in place. In conjunction with divisional and group risk senior management, this team carries out independent risk based credit reviews, providing individual business unit assessment of the effectiveness of risk management practices and adherence to risk controls across the diverse range of the Group s wholesale and retail businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical (standard) credit reviews, non-standard reviews, project reviews, credit risk rating model reviews and bespoke assignments, including impairment reviews as required. The work of group credit risk assurance continues to provide executive and senior management with assurance and guidance on credit quality, effectiveness of credit risk controls and accuracy of impairments.

COLLATERAL

The principal collateral types for loans and advances are:

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

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

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

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

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

MASTER NETTING AGREEMENTS

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

OTHER CREDIT RISK TRANSFERS

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

MONITORING (audited)

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INTENSIVE CARE OF CUSTOMERS IN DIFFICULTY (unaudited)

To support corporate customers that encounter difficulties during the current economic downturn, the Group has continued to expand its dedicated business support unit (BSU) model and established a central team managing this activity globally. Teams have been strengthened in both Wholesale and especially Wealth and International to deal with the rise in workloads experienced during the year as the recessionary conditions took hold both in the UK and overseas. In Wholesale three teams operate to support customers experiencing difficulties in Corporate Real Estate, Corporate and Commercial, and Specialist Finance. In Wealth and International, teams have been created in Ireland and Australia. Under this model, relationship management passes early and fully to BSU; because the BSU specialists receive the customers at an early stage in the process they have more time to develop effective solutions. The strategy is to work alongside management teams and key stakeholders to turn around businesses in distress and re-establish these as viable entities.

These specialist support teams utilise a range of techniques (including debt for equity swaps, sale of business and restructuring options) to preserve viable companies wherever possible and undertake regular reviews so that the customer receives the appropriate level of support. The reviews are also designed to ensure that support strategies continue to be relevant and are being executed.

Where a turnaround is not feasible, exposure is minimised through a combination of appropriate asset sales, restructuring and work-out strategies.

To support UK retail customers who are encountering financial difficulties, the Group has launched a cross-channel support programme. The Group provides support to customers in difficulty via 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 where they have multiple credit facilities including those external to the Group, that require restructuring.

Within collections and recoveries, the sharing of best practice and alignment of policies across the Group has helped to drive more effective customer outcomes and achieve operational efficiencies. The Group has strengthened resources in collections and recoveries to help customers in distress by offering advice and access to a wider range of options such as short-term repayment plans or the government backed Homeowners Mortgage Support and Mortgage Rescue schemes.

A core element of our relationship management approach is to contact customers showing signs of financial distress, discussing with them their circumstances and offering solutions to prevent their accounts falling into arrears.

In addition, the Group participates in the following UK Government (Government) sponsored programmes for households:

Income Support for Mortgage Interest: This is a medium-term Government 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, and the benefit is payable for a maximum of two years. All decisions regarding an individual s eligibility and any amounts payable under the scheme rest solely with the Government. Payments are made directly to the Group by the appropriate Government department.

Homeowner Mortgage Support Scheme: This is a medium-term Government initiative that enables borrowers affected by temporary reductions in income to access reduced payments for a period of up to two years. The Government provides a partial guarantee to the Group whilst a customer participates in the plan. Decisions on eligibility, principally whether the Group expects the borrower s earnings to recover fully, initially rest with the Group and must be made on the basis of detailed information received from an independent fee-free advisor. After a year, the customer must undergo a further full assessment made by the advice agency. The customer must pay at least 30 per cent of the interest due. Any shortfall in payments made during the period covered by the scheme is collected through increased payments over the remaining term.

Mortgage Rescue Scheme: This is a short-term 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.

Breathing space initiative: This is a Government led initiative which requires the banking industry to allow a breathing space of up to sixty days to allow borrowers in difficulty to agree a repayment plan with a debt advice charity prior to any action being taken by the bank to recover the outstanding debt.

Delay Repossession: Under this initiative lenders will not begin repossession proceedings for at least three months when a customer is in arrears. This does not apply to fraud cases. The undertaking comes alongside an existing agreement under which mortgage providers are obliged to explore a range of options, such as payment holidays and altering the terms of a mortgage, before resorting to repossession.

HomeBuy Direct: The HomeBuy Direct scheme covers certain newly built homes on specific housing developments across England. The scheme is provided through HomeBuy agents . HomeBuy agents are housing associations that have been authorised to run schemes for people who have difficulty buying a home. Customers can only buy a home through HomeBuy Direct if their household earnings are no more than £60,000 per annum, and they cannot otherwise afford to buy a home in their area. The HomeBuy Direct scheme is open to people who rent council or housing association properties; key workers in the public sector (e.g. teachers) and first-time buyers. The scheme provides up to 30 per cent of the purchase price through an equity loan that has no repayments for the first five years. After this there is an annual fee of 1.75 per cent, which will increase annually with inflation. The customer can increase their share of ownership at any time.

As well as these Government-sponsored initiatives, the Group, through its banking businesses, also operates a number of its own schemes to assist households. These include:

Short-term reduced or nil arrangements: This is an arrangement whereby customers who are experiencing short-term difficulties may be granted a reduced (including nil) payment arrangement. This is agreed with the customer based on their individual circumstances; nil payment arrangements can be granted for up to three months and reduced payment arrangements for up to six months. There is no reduction in contractual terms for customers on these arrangements.

Term extensions: This allows customers to extend their mortgage term in order to reduce their contractual monthly payment. The maximum term is aligned to the overall standard term limits for mortgages and there is no forbearance of any debt.

Transfer to interest only: This allows customers who are currently on a capital and interest repayment basis to transfer to an interest only basis for a period of time (up to three years maximum) in order to reduce their contractual monthly payment.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Contractual repayment: This scheme allows customers in arrears, but who have made sufficient payments in a six month period, to capitalise their arrears. The contractual repayment is then adjusted to provide full repayment of the loan and full interest within the agreed original term.

The Group s accounting policy for loan renegotiations and forbearance is set out on page F-17.

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

The Lending Code: Introduced by the British Bankers Association in November 2009, the Lending Code is a voluntary set of commitments and standards of good practice to ensure that lenders act fairly and reasonably in all dealings with customers.

Statement of Principles: The Group through a number of its businesses has signed up to the Statement of Principles outlining an agreed approach to working with micro-enterprises (entities with fewer than 10 employees and having a turnover of less than 2 million). The principles include how to ensure that the right relationship is established from the start, how to help if the business faces difficulties and how businesses can work most effectively with their bank.

As part of the Group s commitment to the Statement of Principles, it issues a Letter of Concern to customers when it has concerns about their business or the Group s relationship with them. This ensures that the customer understands the Group s concerns; the approach aims to generate early dialogue between the customer and the Group, so that a joint approach to the situation can be developed.

Business Lending Taskforce: The Group through its banking businesses is actively involved in the recently set up Business Lending Taskforce, which has committed to 17 actions in three broad areas: (i) improving customer relationships; (ii) ensuring better access to finance; and (iii) providing better information and promoting understanding.

SUCCESS OF THE SCHEMES (unaudited)

As the Government programmes are relatively new and the economic conditions in a number of the Group s markets remain challenging, it is too early to judge which of these plans will be ultimately successful. However, initial signs are encouraging, with the Homeowner s Mortgage Support Scheme showing increased levels of contact by customers, either directly with us or via the fee-free advice sector. This has allowed solutions (whether Government- or internally-led) to be put in place which may not otherwise have been considered. This programme has also led to improved relationships between collections teams, local authorities and advisors.

The Income Support for Mortgage Interest scheme remains the most successful of the schemes. It is the longest-running, is the most widely understood and provides both the customer and the Group with an assurance as to the maintenance of two years worth of interest payments. The Group estimates that around 60,000, or less than 2 per cent, of its mortgage borrowers are receiving this benefit.

The Group s own schemes have also shown signs of success with customers who have accepted interest-only transfers, term extensions and product transfers maintaining their revised monthly payment going forward in over 50 per cent of cases. The Group believes that its reduced payment arrangements continue to be an effective way to manage short-term affordability issues. Approximately one in seven customers impacted is able to return to standard terms within twelve months.

MEANS OF COMMUNICATION WITH CUSTOMERS IN DISTRESS (unaudited)

The Group uses a series of active management processes to manage it customer relationships and to inform its customers of the options and programmes available to them. These tend to involve a constant two-way dialogue between the customer and the Group.

Customers are informed of:

the availability of self-help via our banking websites;

money management advice and budgeting advice supplied through our branch and telephony networks;

the ability to reschedule existing unsecured Lloyds Banking Group debt through the use of other Group products;

mortgage product transfers and term extensions; and

short-term repayment holidays for customers in temporary difficulties.

The Group also seeks to ensure that its customers are aware of the help available from external fee-free advice organisations such as the Citizens Advice Bureau.

As the customers accounts referred to above are current at the time of the contact and have no arrears, it is not possible to determine which customers who acted upon the advice provided would otherwise have become past due or impaired. Neither is it possible to measure the success of this customer service activity accurately, as many customers will identify solutions themselves based on reviewing the Group s websites or talking with staff in the Group s branches and on the telephone without the need for any financial rescheduling.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE GROUP S CREDIT RISK PORTFOLIO

OVERVIEW (unaudited)

The Group achieved a significant reduction in the impairment charge in 2010 to £13,181 million (from £23,988 million in 2009), due to the stabilisation of the wholesale portfolios and good retail affordability and performance. Improvements in Wholesale and Retail more than offset increased impairment charges in Ireland and Australia, caused by difficult market conditions.

Prudent, through the cycle credit policies and procedures are in place throughout the Group, focusing on development of enduring client relationships. This resulted in higher quality new business being originated across the UK. Very little new origination took place outside the UK.

The Group s level of impairment is being managed successfully in the current challenging economic environment by the Wholesale business support units and Retail collection and recovery units. The business support model has been expanded from Wholesale across Wealth and International division, with a central team established to manage its business support activity globally. The Group has also strengthened resources within Retail collections and recoveries to enable more timely engagement with customers experiencing difficulties to drive more effective customer outcomes.

The Group actively reduced limits to Portugal, Ireland, Italy, Greece and Spain over the last two years, with the associated country risk profile modest in the context of the Group s asset base. Except for Ireland, the 2011 base case impairment forecast for these countries is de-minimis in the context of the Group.

The closure of the Bank of Scotland (Ireland) Limited business was completed on the 31 December 2010 and a new operating structure came into existence, focused on intensive management of the closed book to optimise the winding up of our lending.

IMPAIRMENTS ON GROUP LOANS AND ADVANCES (audited)

As at 31 December 2010	**Loans and advances £m**	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans %**
Retail	**368,981**	**9,750**	**2.6**	**3,096**	**31.8**
Wholesale	**187,651**	**34,514**	**18.4**	**15,855**	**45.9**
Wealth and International	**66,368**	**20,342**	**30.7**	**10,684**	**52.5**
Hedging and other items	**3,378**				
	626,378	**64,606**	**10.3**	**29,635**	**45.9**
Impairment provisions	**(29,635)**				
Fair value adjustments	**(4,146)**				
	592,597				
As at 31 December 2009					
Retail	378,005	11,015	2.9	3,806	34.6
Wholesale	210,934	35,114	16.6	17,179	48.9
Wealth and International	69,402	12,704	18.3	5,003	39.4
Hedging and other items	1,663				
	660,004	58,833	8.9	25,988	44.2
Impairment provisions	(25,988)				
Fair value adjustments	(7,047)				
	626,969				

1 Impairment provisions include collective unimpaired provisions.

IMPAIRMENT CHARGE BY DIVISION (audited)

	2010 **£m**	2009 £m	Change %
Retail	**2,747**	4,227	35
Wholesale	**4,446**	15,683	72
Wealth and International	**5,988**	4,078	(47)
Total impairment charge	**13,181**	23,988	45

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EUROPEAN SOVEREIGN EXPOSURES (unaudited)

As at 31 December 2010, the Group had in aggregate, minimal direct exposure to the national and local governments of Portugal, Ireland, Italy, Greece and Spain.

OUTLOOK GROUP (unaudited)

Based on its latest economic assumptions, as set out on page 12, the Group expects an improved impairment charge in 2011 compared with 2010.

While the second half of 2010 saw most countries exiting from recession, forecasts are that the UK recovery will continue to be at a modest pace and is likely to be protracted. The risks to the impairment charge remain skewed to the downside across all lending businesses. In the UK, business and consumer confidence remain fragile and the extent to which simultaneous fiscal tightening might undermine global and UK growth is unclear. Contagion from the Irish bail-out to other Eurozone economies could drive further fiscal tightening and worsen the outlook further. Rising commodity prices driven by strong recovery in Asia might fuel a further increase in inflation, prompting short-term interest rates to rise more quickly than anticipated. Potential interest rate rises, public spending cuts and reduced consumer spending could cause cashflow stress and higher levels of default amongst mid-market corporates and Commercial customers in particular. In addition, in our commercial real estate book, any deterioration in the economy could increase the level of tenant defaults and reduce capital values further from an already depressed level, particularly amongst those property assets not located in London or other major UK cities. Further significant falls in house prices, real disposable household income or increasing interest rates, would most likely result in a higher secured retail impairment charge relative to current expectations.

A double-dip scenario a second recession following closely the one from which the economy is just emerging remains a key downside risk to UK impairment charges. This is because it would result in further significant increases in corporate failures and unemployment during 2011-12. In addition, residential and commercial property would suffer a second period of falling prices, tenant defaults would increase and central banks would have limited ability to cushion the downturn. Together, these factors could lead to increased impairments across the Group s UK portfolios.

The Group s exposure to Ireland and Australia is being closely managed. Following the 85 billion joint EU/IMF financial assistance programme for Ireland, the fragility of the Irish economy and political system could cause further credit quality deterioration within our Irish lending portfolio, which is closed to new customers. Australia, while benefiting from a commodities export boom, continues to be adversely affected by deteriorating property markets in the geographic areas and property classes where the Group is exposed. Base rate increases are an additional threat to affordability in our Australian property and acquisition finance books.

RETAIL

OVERVIEW (unaudited)

The Retail impairment charge was £2,747 million in 2010, a decrease of £1,480 million, or 35 per cent, from 2009.

The decrease in the Retail impairment charge was driven primarily by the improved quality of new business and effective portfolio management, coupled with a continuing slow recovery of the economy. The Retail impairment charge for loans and advances to customers, as an annualised percentage of average loans and advances to customers, decreased to 0.74 per cent from 1.11 per cent in 2009.

New lending quality continues to be good with subsequent early arrears at pre-recessionary levels.

Average loan-to-value on new mortgage lending in the year was 60.9 per cent (59.3 per cent for 2009) while the average indexed loan-to-value on the mortgage portfolio was 55.6 per cent (54.8 per cent at 31 December 2009) consistent with a net fall in house prices since December 2009.

Overall volume of customers entering arrears in 2010 compared to 2009 was lower for unsecured lending and flat for secured lending. Secured early arrears balances increased in the second half of 2010.

RETAIL IMPAIRMENT CHARGE (audited)

	2010 £m	2009 £m	Change %
Secured	**292**	789	63
Unsecured	**2,455**	3,438	29
Total impairment charge	**2,747**	4,227	35

Retail s impairment charge decreased by £1,480 million to £2,747 million in 2010 compared with 2009 and was lower in both secured and unsecured portfolios. This improvement was driven primarily by the improved quality of new business and effective portfolio management, coupled with the continuing slow recovery of the economy. The lower secured impairment charge reflected a reduction in impaired loans and improved arrears in the first half of 2010. Across Retail in 2010, there were fewer cases going into arrears. The impairment charge on loans and advances to customers, as an annualised percentage of average loans and advances to customers, decreased to 0.74 per cent from 1.11 per cent in 2009.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRED LOANS AND PROVISIONS (audited)

Retail impaired loans decreased by £1.2 billion to £9.8 billion compared with 31 December 2009 and, as a percentage of closing loans and advances to customers, decreased to 2.6 per cent from 2.9 per cent at 31 December 2009. The reduction in the value of impaired loans reflected the continuing low interest rate environment for mortgages and fewer unsecured loans going into arrears. Impairment provisions, as a percentage of impaired loans, reduced to 31.8 per cent from 34.6 per cent at 31 December 2009 largely driven by more stringent criteria for new and existing unsecured collections repayment plans resulting in highly provided assets being written-off.

IMPAIRMENTS ON RETAIL LOANS AND ADVANCES (audited)

As at 31 December 2010	**Loans and advances £m**	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans %**
Secured	**341,069**	**6,769**	**2.0**	**1,589**	**23.5**
Unsecured	**27,912**	**2,981**	**10.7**	**1,507**	**50.6**
Total gross lending	**368,981**	**9,750**	**2.6**	**3,096**	**31.8**
Impairment provisions	**(3,096)**				
Fair value adjustments	**(2,154)**				
	363,731				

As at 31 December 2009	Loans and advances £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
Secured	345,900	7,196	2.1	1,693	23.5
Unsecured	32,105	3,819	11.9	2,113	55.3
Total gross lending	378,005	11,015	2.9	3,806	34.6
Impairment provisions	(3,806)				
Fair value adjustments	(3,141)				
	371,058				

1 Impairment provisions include collective unimpaired provisions.

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

RETAIL LOANS AND ADVANCES TO CUSTOMERS (audited)

As at 31 December	**2010 £m**	2009 £m
Secured:		
Mainstream	**265,368**	270,069
Buy to let	**46,356**	44,236
Specialist	**29,345**	31,595
	341,069	345,900

Unsecured:		
Credit cards	**11,207**	12,301
Personal loans	**13,881**	16,940
Bank accounts	**2,624**	2,629
Others, including joint ventures	**200**	235
	27,912	32,105
Total Retail gross lending	**368,981**	378,005

OUTLOOK RETAIL (unaudited)

The Group remains cautious about the pace and consistency of economic recovery and how this may impact our customers. The outlook assumes a slow economic recovery resulting in an improvement in the unsecured impairment charge. In the secured portfolio however, there are a mixture of signals from lead indicators, including falling house prices and an increase in secured arrears in the second half of 2010, which lead Retail to expect a higher secured impairment charge in 2011. Overall the Group anticipates a modest reduction in Retail s 2011 impairment charge based on the current outlook of a modestly improving economic environment.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

SECURED

SECURED IMPAIRMENT CHARGE (unaudited)

The impairment charge decreased by £497 million, to £292 million in 2010 compared to the previous year. The main drivers of the reduction were continued benefits from internal activities (risk and collections policies), maintained affordability and the continuing slow recovery of the economy. However, for the second half of 2010 the impairment charge was greater than the first half due to falling house prices combined with a worsening house price outlook towards the end of the period. The impairment charge for loans and advances to customers, as a percentage of average loans and advances to customers, decreased to 0.09 per cent from 0.23 per cent in 2009.

Provisions held against secured assets reflect adequate allowance for incurred losses including customers currently on repayment plans or in financial difficulties who are maintaining their repayments whilst interest rates are very low.

SECURED IMPAIRED LOANS (unaudited)

Impaired loans decreased by £0.4 billion to £6.8 billion at 31 December 2010 and, as a percentage of closing loans and advances to customers, reduced to 2.0 per cent from 2.1 per cent at 31 December 2009. The reduction in the value of impaired loans reflects the continued ability of customers to afford their mortgage payments in a low interest rate environment.

The number of customers going into arrears remained stable throughout 2010. In the second half of 2010 fewer accounts in arrears returned to order resulting in higher early arrears balances for 31 December 2010 compared to 30 June 2010. As reported at the 2009 year end, Specialist lending remains closed to new business and this book is in run-off.

SECURED ARREARS (unaudited)

The percentage of mortgage cases greater than three months in arrears (excluding repossessions) remained stable at 2.3 per cent at 31 December 2010 compared to 31 December 2009.

MORTGAGES GREATER THAN THREE MONTHS IN ARREARS (EXCLUDING POSSESSIONS) (audited)

Greater than three months in arrears (excluding repossessions)	**Number of cases**		**Percentage of total mortgage accounts**	
	31 December 2010 Cases	31 December 2009 Cases	**31 December 2010 %**	31 December 2009 %
Mainstream	**55,675**	57,837	**2.1**	2.1
Buy to let	**7,577**	7,557	**1.8**	1.9
Specialist	**12,582**	13,848	**6.4**	6.6
Total	**75,834**	79,242	**2.3**	2.3

Greater than three months in arrears (excluding repossessions)	**Value of debt[1]**		**Percentage of total mortgage balances**	
	31 December 2010 £m	31 December 2009 £m	**31 December 2010 %**	31 December 2009 %

Mainstream	**6,247**	6,407	**2.4**	2.4
Buy to let	**1,157**	1,159	**2.5**	2.6
Specialist	**2,262**	2,498	**7.7**	7.9
Total	**9,666**	10,064	**2.8**	2.9

1 Value of debt represents total book value of mortgages in arrears but not repossessed.

The stock of repossession cases rose from 2,720 at 31 December 2009 to 3,043 at 31 December 2010. This still represents a relatively low proportion of the portfolio and was broadly consistent with prior years.

Secured loan to value analysis (unaudited)

Management actions have resulted in new lending quality remaining strong. The average loan-to-value ratio (LTV) for new mortgages and further advances written in 2010 was 60.9 per cent compared with 59.3 per cent for 2009. This is primarily driven by a greater proportion of new lending to first-time buyers and home movers delivering on the Group s commitment to support new home owners. The average indexed LTV on the mortgage portfolio at 31 December 2010 was 55.6 per cent compared with 54.8 per cent at 31 December 2009. House prices, having initially increased, fell in the second half of 2010 resulting in the indexed LTV in excess of 100 per cent ending 2010 at 13.2 per cent of the mortgage portfolio (£44.9 billion), compared with 13.0 per cent (£44.8 billion) at 31 December 2009. The tables below show LTVs across the principal mortgage portfolios.

The increased average LTVs for impaired Buy to let mortgages, is driven by the modest net fall in house prices and the seasoning of higher risk lending that was closed at the start of 2009.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

ACTUAL AND AVERAGE LTVS ACROSS THE PRINCIPAL MORTGAGE PORTFOLIOS (audited)

As at 31 December 2010	**Mainstream %**	**Buy to let %**	**Specialist[1] %**	**Total %**
Less than 60%	**33.0**	**11.4**	**14.0**	**28.5**
60% to 70%	**12.1**	**11.1**	**9.4**	**11.7**
70% to 80%	**16.1**	**21.9**	**15.9**	**16.8**
80% to 90%	**15.3**	**18.0**	**21.3**	**16.2**
90% to 100%	**11.9**	**19.1**	**20.0**	**13.6**
Greater than 100%	**11.6**	**18.5**	**19.4**	**13.2**
Total	**100.0**	**100.0**	**100.0**	**100.0**
Average loan-to-value:				
Stock of residential mortgages	**51.9**	**75.6**	**72.9**	**55.6**
New residential lending	**60.0**	**66.5**	**n/a**	**60.9**
Impaired mortgages	**72.3**	**97.8**	**87.3**	**78.0**

As at 31 December 2009	Mainstream %	Buy to let %	Specialist[1] %	Total %
Less than 60%	34.4	12.0	14.3	29.7
60% to 70%	11.9	11.3	9.7	11.6
70% to 80%	15.2	20.2	17.0	16.0
80% to 90%	14.3	19.1	21.5	15.6
90% to 100%	12.2	21.4	20.3	14.1
Greater than 100%	12.0	16.0	17.2	13.0
Total	100.0	100.0	100.0	100.0
Average loan-to-value:				
Stock of residential mortgages	51.0	75.2	72.3	54.8
New residential lending	58.3	65.6	73.7	59.3
Impaired mortgages	71.1	91.5	85.6	76.5

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

UNSECURED (unaudited)

In 2010 the impairment charge on loans and advances to customers reduced by £983 million to £2,455 million compared with 2009. This reflected a continuation of the improving portfolio trends resulting from the Group s prudent risk appetite, with a focus on lending towards existing customers, combined with stable unemployment.

A combination of reduced demand from customers for personal unsecured borrowing and the Group s prudent risk policy contributed to loans and advances to customers reducing by £4.2 billion to £27.9 billion at 31 December 2010.

Impaired loans decreased by £0.8 billion to £3.0 billion which represented 10.7 per cent of closing loans and advances to customers at 31 December 2010, compared with 11.9 per cent at 31 December 2009. The movement in impaired loans is consistent with the trends seen in both the flow of accounts to arrears and arrears balances, both of which have fallen across all unsecured products during 2010. This is a result of tightening credit policy across the credit lifecycle, including stronger controls on customer affordability, set against a stable economic environment. Retail s exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers changing financial circumstances. The portfolios results are supported by pre-recessionary levels of early arrears for accounts acquired in the last two years, highlighting an underlying improvement in the risk profile of the business.

Impairment provisions decreased by £0.6 billion, compared with 31 December 2009, to £1.5 billion. Impairment provisions, as a percentage of impaired loans, decreased to 50.6 per cent at 31 December 2010 from 55.3 per cent at 31 December 2009, largely driven by more stringent criteria for new and existing unsecured collections repayment plans resulting in highly provided assets being written-off.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WHOLESALE

OVERVIEW (unaudited)

Impairment charge for 2010 decreased significantly to £4,446 million, from £15,683 million for 2009.

Impairment experience in 2010 was better than guided a year ago as stabilising economic conditions led to lower impairment charges especially in the corporate real estate, real estate related and Corporate (UK and US) portfolios.

A robust credit risk management and control framework is in place across the combined portfolios and a prudent risk appetite approach (largely based on Lloyds TSB s model) continues to be embedded across the division. Significant resources have been deployed into the business support units focused on key and vulnerable obligors and asset classes.

WHOLESALE IMPAIRMENT CHARGE (audited)

	2010 £m	2009 £m	Change %
Corporate Markets	**4,182**	14,855	72
Asset Finance	**264**	828	68
Total impairment charge	**4,446**	15,683	72

Wholesale s impairment charge decreased by £11,237 million, or 72 per cent, compared to £15,683 million for 2009. Impairment charges as an annualised percentage of average loans and advances to customers reduced to 2.08 per cent from 5.92 per cent in 2009. Significant actions were taken in the first half of 2009 on the heritage HBOS portfolios, including the identification of large impairments post the HBOS acquisition especially in corporate real estate, real estate related and Corporate (UK and US) portfolios. Together with the stabilising UK and US economic environment in 2010, a low interest rate environment helping to maintain defaults at a lower level and a number of write backs due to asset disposals, impairment charges have decreased substantially compared with 2009.

IMPAIRED LOANS AND PROVISIONS (audited)

Wholesale s impaired loans reduced by £600 million to £34,514 million compared with 31 December 2009. The reduction is due to new impaired assets (mainly in the Corporate Real Estate Business Support Unit) being offset by write-offs on irrecoverable assets and the sale of previously impaired assets. Impairment provisions also reduced as a result of the write-offs and a lower impairment rate on recently impaired assets. As a result, impairment provisions as a percentage of impaired loans reduced to 45.9 per cent from 48.9 per cent at 31 December 2009. As a percentage of closing loans and advances to customers, impaired loans increased to 18.4 per cent from 16.6 per cent at 31 December 2009. This increase is essentially a factor of the reducing level of total loans and advances to customers as at 31 December 2010 compared with 31 December 2009. We continue to monitor our vulnerable portfolios within Wholesale and, where appropriate, remedial risk mitigating actions are being undertaken.

OUTLOOK WHOLESALE (unaudited)

The potential effects of the UK Government s austerity measures on portfolios vulnerable to Government spending cuts are currently unknown. Although appropriate early warning indicators and action plans are in place to help mitigate against this, we would expect some negative effect on the portfolio. This is especially so in the traditional customer lending businesses, which are vulnerable to reduced consumer spending as a result of tax rises, and other UK Government austerity measures. As previously guided, we expect the overall net impairment charges in our traditional lending businesses (especially in the trading and manufacturing sectors) to increase in 2011, driven in part by a lower benefit from write backs on asset disposals and the effect of the UK Government austerity measures on the wider economy.

Wholesale retains some material single obligor concentrations on weaker credits, especially from the heritage HBOS real estate and real estate related portfolios. These portfolios (especially the secondary and tertiary assets which comprise a large part of the heritage HBOS corporate real estate and real estate related portfolio) remain vulnerable to an increase in tenancy defaults and reduced capital values from an already depressed level, particularly in the regions. However, against our base case assumptions, we expect our impairment charges in corporate real estate to be lower than 2010 as a result of a continuing stabilisation of the existing portfolio and actions taken in 2009 and 2010. Whilst we therefore remain cautious in respect of the outlook for 2011, we do expect a modest reduction in the total impairment charge for 2011 as a whole.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENTS ON WHOLESALE LOANS AND ADVANCES (audited)

As at 31 December 2010	**Balance £m**	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans %**
Corporate Markets:					
Corporate	**81,171**	**6,635**	**8.2**	**3,629**	**54.7**
Commercial	**29,148**	**2,856**	**9.8**	**993**	**34.8**
Corporate Real Estate BSU	**26,151**	**17,518**	**67.0**	**8,091**	**46.2**
Wholesale Equity	**140**	**108**	**77.1**	**107**	**99.1**
Wholesale Markets	**40,042**	**5,718**	**14.3**	**1,992**	**34.8**
Total Corporate Markets	**176,652**	**32,835**	**18.6**	**14,812**	**45.1**
Treasury and Trading	**1,050**				
Asset Finance	**9,949**	**1,679**	**16.9**	**1,043**	**62.1**
Total Wholesale	**187,651**	**34,514**	**18.4**	**15,855**	**45.9**
Reverse repos	**3,096**				
Impairment provisions	**(15,855)**				
Fair value adjustments	**(1,665)**				
Loans and advances to customers	**173,227**				
Loans and advances to banks	**12,409**				
Debt securities[2]	**25,781**				
Available-for-sale financial assets[3]	**29,458**				

1 Impairment provisions include collective unimpaired provisions.

2 Of which Wholesale Markets is £25,120 million, Wholesale Equity £487 million, Treasury and Trading £163 million, Asset Finance £7 million, Corporate £2 million and Commercial £2 million.

3 Of which Wholesale Markets is £21,279 million, Wholesale Equity £2,109 million, Treasury and Trading £6,011 million and Corporate £59 million.

As at 31 December 2009	Balance £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
Corporate Markets:					
Corporate	96,865	9,362	9.7	4,698	50.2
Commercial	29,223	2,695	9.2	956	35.5
Corporate Real Estate BSU	25,509	16,505	64.7	8,234	49.9
Wholesale Equity	505	413	81.8	385	93.2
Wholesale Markets	44,606	4,170	9.3	1,675	40.2
Total Corporate Markets	196,708	33,145	16.8	15,948	48.1
Treasury and Trading	1,394				
Asset Finance	12,832	1,969	15.3	1,231	62.5
Total Wholesale	210,934	35,114	16.6	17,179	48.9
Reverse repos	1,108				
Impairment provisions	(17,179)				
Fair value adjustments	(3,055)				
Loans and advances to customers	191,808				
Loans and advances to banks	18,862				
Debt securities	31,736				
Available-for-sale financial assets	36,867				

1 Impairment provisions include collective unimpaired provisions.

CORPORATE (unaudited)

The £81,171 million of loans and advances to customers in the Corporate portfolio is structured across a number of different portfolios and sectors as discussed below:

UK and US Corporate Showed resilience during 2010 with the impairment charge significantly lower than 2009 levels and modest recoveries as asset prices improved during the first half of the year. Sentiment among UK corporates during the second half of the year changed as the scale of the Government austerity measures became clearer although most effects are not expected to be felt until 2011. Major corporate balance sheets are relatively strong with adequate levels of undrawn committed bank facilities available and continued access to the capital markets. In the Corporate North American portfolio significant reductions were achieved in the non-core portfolio, mostly in the first half when secondary markets were fairly buoyant. Impairments were significantly lower than in 2009 albeit the overall position is improved by some write backs.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Mid-market Corporate As anticipated, the slightly more benign conditions experienced in the first half of 2010 were not sustained in the second half in the corporate mid-market. Impairments rose during the second half of the year, albeit to levels still significantly below those experienced in 2009, with legacy issues in the heritage HBOS portfolio continuing to be a significant driver of impairments in 2010. Although a number of exporters have been able to take advantage of a beneficial exchange rate, the corporate middle market is dominated by domestically focused businesses and the prospect of public sector spending cuts, tax increases and continuing high commodity and import prices is likely to see confidence remain fragile in 2011.

Corporate Real Estate The focus is to continue to improve and re-balance the risk profile of the existing portfolio and apply conservative and prudent lending policies in relation to new business. A significant percentage concentration of customer lending is in real estate and real estate related investment lending, especially heritage HBOS and sustainability of its cashflow in 2010 has been key to the relative resilience seen in the investment market to date. The portfolio remains vulnerable to tenant default and asset price falls due to a significant element of investment lending in the portfolio, a large element of which is supported by secondary or tertiary assets. Refinancing risk remains an emerging issue with significant maturities due in the next few years.

Financial Institutions As part of the Group s funding, liquidity and general hedging requirements, Corporate maintains relationships with many major financial institutions throughout the world. During the second half of 2010, concerns about sovereign fiscal deficits and public sector debt levels increased our scrutiny of the European banking sector, in particular the weaker Eurozone countries. Trading exposures are in large part collateralised and interbank activity is mainly with high investment grade counterparties.

COMMERCIAL (unaudited)

The Commercial portfolio s impairment experience has remained steady throughout the year, although a slightly higher run rate was observed in the second half, but overall was materially below that incurred in 2009. Portfolio metrics including delinquencies and assets under close monitoring, while improving through supportive management actions, remain above benign levels.

CORPORATE REAL ESTATE BUSINESS SUPPORT UNIT (unaudited)

The Corporate Real Estate Business Support Unit portfolios have endured a significant level of stress as a consequence of the unprecedented scale and pace of deterioration in the property sector since the peak in 2007, coupled with the previous aggressive lending appetite in the heritage HBOS business. Against significant impairments taken in 2009, experience in 2010 is materially lower. This reflects the stabilising economic environment and the prudent provisioning undertaken on the HBOS corporate real estate and real estate related portfolio in 2009. The Group continues to remain cautious regarding the short to medium term prospects for the sector.

The management of the distressed portfolio remains key not only to mitigating loss for the Group, but also for the Group as a major lender within the property sector to ensure that the strategies adopted do not adversely impact on a market that remains fragile. During 2010, a number of restructurings, good level of asset reduction, and continued active management led to a fall in impairments compared to the previous year.

On the property investment side there have been signs of recovery in capital values, specifically at the prime end of the commercial market and in London generally. Since the half year, this recovery has slowed as investor activity and sentiment cooled. Rental values remain fragile across most property sectors.

WHOLESALE EQUITY (unaudited)

The Wholesale Equity portfolio (assets representing Equity Risk including ordinary equity, preference shares and debt securities) totals £5.6 billion (split £4.2 billion on balance sheet commitments and £1.4 billion as yet undrawn, the majority of which relates to the Funds Investment business). The portfolio comprises five businesses: Lloyds Development Capital, Project Finance, Joint Ventures Equity, BSU Investment portfolios and Fund Investments.

In terms of market sentiment, the second half of 2010 saw a gradual uptick in main share indices (UK, Europe and USA) which, despite episodic volatility has contributed to a relatively stable valuation position combined with some indication that there may be a slow recovery in market activity. While signs are on balance currently positive, we remain cautious on prospects for value recovery looking into 2011.

WHOLESALE MARKETS (unaudited)

Loans and advances to customers of £40.0 billion largely comprise balances in the Structured Corporate Finance portfolio, which includes Acquisition Finance (leveraged lending £11.6 billion), Project Finance and asset based finance. The Acquisition Finance portfolio continues to be significantly affected by the economic environment, with a relatively high proportion of deals being restructured. The rate of new problem loans started to abate in the second half of 2009 and this trend continued during 2010. Refinancing risk is an issue for Acquisition Finance, with significant loan maturities due in the next few years. In Ship Finance, global markets, especially the dry bulk and container sectors, experienced considerable pressure during 2009, leading to higher impairment levels. The container sector strengthened during 2010, but the Group expects the shipping sector to remain challenging into 2011.

Wholesale Markets is also responsible for the Treasury Assets portfolio which mainly encompasses a portfolio of Asset-Backed Securities (ABS) and financial institution Floating Rate Note positions. Further details of Wholesale Division s Asset-Backed Securities is provided in note 18 to the financial statements. The size of the Treasury Assets portfolio has reduced through asset sales and amortisation.

TREASURY AND TRADING (unaudited)

Treasury and Trading acts as the link between the wholesale markets and the Group s balance sheet management activities and provides pricing and risk management solutions to both internal and external clients.

The portfolio comprises £10.7 billion of loans and advances to banks, £6.0 billion of Available-for-Sale debt securities and £1.1 billion of loans and advances to customers (excluding reverse repos).

The majority of Treasury and Trading s funding and risk management activity is transacted with investment grade counterparties and much of it is on a secured basis, such as repos. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement. Treasury and Trading has reduced the government bond portfolio in response to growing concern over market conditions in Europe. The credit quality of the government bond portfolio is almost solely AAA rated sovereign debt.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

ASSET FINANCE (unaudited)

The credit quality of the retail portfolios continues to be relatively stable with key risk indicators continuing to show signs of improvement. Impairments in 2010 were lower than anticipated, particularly in the second charge secured portfolio and the retail motor loans portfolio. Asset quality also continues to improve in response to the continuing strategy to enhance the quality of new business written and following the closure of new business by the Personal Financial Services business. The credit quality profile across the non-retail portfolios also continues to be relatively stable, and impairment levels significantly less than 2009, reflecting a material slow down in new default cases. Exposures to the Fleet Operator sector, particularly a small number of daily/flexi rental operators, continue to require intensive management to support customers through their financial difficulties, but have not affected impairment levels to the extent seen in 2009.

WEALTH AND INTERNATIONAL

OVERVIEW (unaudited)

Increased impairment charges in commercial real estate portfolios in Ireland and Australia were the primary drivers of a divisional increase in impairment of 47 per cent in 2010 compared with 2009.

Impairment charges in Ireland increased significantly in the last quarter of 2010 reflecting a material deterioration in market conditions that resulted in EU-IMF financial support in late November 2010.

As part of the closure of Bank of Scotland (Ireland) Limited, a dedicated UK based business support unit credit team has been put in place to manage the wind down of the Irish book.

Increased impairment charges in Australia are primarily due to real estate concentrations in specific geographical and industry sectors where liquidity has significantly contracted in 2010.

WEALTH AND INTERNATIONAL IMPAIRMENT CHARGE (audited)

	2010	2009	Change
	£m	£m	%
Wealth	**46**	71	35
International:			
Ireland	**4,264**	2,949	(45)
Australia	**1,362**	849	(60)
Wholesale Europe	**210**	129	(63)
Other	**106**	80	(33)
	5,942	4,007	(48)
Total impairment charge	**5,988**	4,078	(47)

Wealth and International s impairment charge increased by £1,910 million to £5,988 million in 2010 compared with 2009. Impairment charges as a percentage of average loans and advances to customers increased to 8.90 per cent from 6.04 per cent in 2009.

IMPAIRED LOANS AND PROVISIONS (audited)

Total impaired loans increased by £7,638 million to £20,342 million compared with £12,704 million at 31 December 2009 and as a percentage of closing loans and advances to customers increased to 30.7 per cent from 18.3 per cent at 31 December 2009. The level of impaired loans in the International business is supported by detailed portfolio reviews conducted during 2010.

In December 2010, responsibility for impaired assets in Ireland was transferred from the local BSU team to a dedicated UK based BSU credit team to manage the wind down of the lending book. In Australia, this activity continues to be managed locally and strengthened through deployment of additional staff. Responsibility for these areas has been consolidated within a new central team, which has considerable experience in work-out strategies and will manage this activity globally for the Group.

Impairment provisions as a percentage of impaired loans increased to 52.5 per cent from 39.4 per cent at 31 December 2009. In the International business the increase in impairment provisions is due to a higher level of impaired loans and an increased coverage level, particularly in Ireland.

OUTLOOK WEALTH AND INTERNATIONAL (unaudited)

Impairment charges in the division are expected to reduce in 2011 compared to the current year charge, although economic conditions in Ireland continue to be monitored closely. The outlook also remains cautious for the Group s Australian exposures, where there continues to be limited liquidity in regional property markets to which the Group is exposed.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENTS ON WEALTH AND INTERNATIONAL LOANS AND ADVANCES (audited)

As at 31 December 2010	**Loans and advances £m**	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans %**
Wealth	**9,472**	**353**	**3.7**	**116**	**32.9**
International:					
Ireland	**27,428**	**14,445**	**52.7**	**7,763**	**53.7**
Australia	**14,587**	**4,187**	**28.7**	**2,208**	**52.7**
Wholesale Europe	**7,322**	**1,007**	**13.8**	**420**	**41.7**
Other	**7,559**	**350**	**4.6**	**177**	**50.6**
	56,896	**19,989**	**35.1**	**10,568**	**52.9**
Wealth and International	**66,368**	**20,342**	**30.7**	**10,684**	**52.5**
Impairment provisions	**(10,684)**				
Fair value adjustments	**(327)**				
	55,357				

As at 31 December 2009	Loans and advances £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £	Impairment provisions as a % of impaired loans %
Wealth	9,523	281	3.0	100	35.6
International:					
Ireland	29,104	9,712	33.4	3,601	37.1
Australia	14,057	2,030	14.4	966	47.6
Wholesale Europe	8,781	537	6.1	243	45.3
Other	7,937	144	1.8	93	64.6
	59,879	12,423	20.7	4,903	39.5
Wealth and International	69,402	12,704	18.3	5,003	39.4
Impairment provisions	(5,003)				
Fair value adjustments	(851)				
	63,548				

1 Impairment provisions include collective unimpaired provisions.

WEALTH (audited)

Total impaired loans increased by £72 million, or 26 per cent to £353 million compared with £281 million at 31 December 2009 and as a percentage of closing loans and advances increased to 3.7 per cent from 3.0 per cent at 31 December 2009. Impairment charges decreased by £25 million to £46 million compared to £71 million in 2009. This reduction is primarily due to the mortgage lending business in Spain where there has been improved credit management of the book during 2010.

IRELAND (audited)

Total impaired loans increased by £4,733 million, or 49 per cent to £14,445 million compared with £9,712 million at 31 December 2009 and as a percentage of closing loans and advances increased to 52.7 per cent from 33.4 per cent at 31 December 2009. Impairment charges increased by £1,315 million to £4,264 million compared to £2,949 million in 2009. Impairment charges as a percentage of average loans and advances to customers increased to 15.4 per cent from 9.9 per cent in 2009.

Further deterioration in the Irish economy resulted in increased impaired loans in 2010 and coverage levels significantly increased in the last quarter of 2010 reflecting downward revisions in the Group s Irish economic assumptions.

IMPAIRMENTS ON IRELAND LOANS AND ADVANCES (audited)

As at 31 December 2010	**Gross loans £m**	**Impaired loans £m**	**Provisions £m**
Commercial Real Estate	**11,685**	**9,232**	**4,791**
Corporate	**8,070**	**4,343**	**2,356**
Retail	**7,673**	**870**	**616**
Total	**27,428**	**14,445**	**7,763**

As at 31 December 2009	Gross loans £m	Impaired loans £m	Provisions £m
Commercial Real Estate	11,738	6,114	2,154
Corporate	9,094	3,002	1,159
Retail	8,272	596	288
Total	29,104	9,712	3,601

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The most significant contribution to impairment in Ireland is the commercial real estate portfolio. Impairment provisions provide 52 per cent coverage on impaired commercial real estate loans reflecting peak to trough falls in commercial property and house prices widening to 60 per cent and 38 per cent respectively. Mortgage lending at the year end comprised 96 per cent of the retail portfolio with impaired loans of £0.8 billion and impairment coverage of 65 per cent.

Following the closure of the Irish business, the portfolio is in run-off although current levels of redemptions and recoveries are low due to a severe lack of liquidity.

AUSTRALIA (audited)

Total impaired loans increased by £2,157 million, or 106 per cent to £4,187 million compared with £2,030 million at 31 December 2009 and as a percentage of closing loans and advances increased to 28.7 per cent from 14.4 per cent at 31 December 2009. Impairment charges increased by £513 million to £1,362 million compared to £849 million in 2009. Impairment charges as a percentage of average loans and advances to customers increased to 9.3 per cent from 6.3 per cent in 2009.

Although the economic performance for Australia has been more robust, exposure to the New Zealand and non-metropolitan Australian commercial real estate sectors remains a key influence on impairment performance. These markets have suffered a significant reduction in liquidity in 2010, driving increased impaired lending and also constraining recoveries.

WHOLESALE EUROPE (audited)

Total impaired loans increased by £470 million, or 88 per cent to £1,007 million compared with £537 million at 31 December 2009 and as a percentage of closing loans and advances increased to 13.8 per cent from 6.1 per cent at 31 December 2009. Impairment charges increased by £81 million to £210 million compared to £129 million in 2009. Impairment charges as a percentage of average loans and advances to customers increased to 2.8 per cent from 2.3 per cent in 2009. Commercial real estate is the primary driver of the impairment charge in Wholesale Europe reflecting a small number of specific transactions.

OTHER INTERNATIONAL (audited)

Total impaired loans increased by £206 million, or 143 per cent to £350 million compared with £144 million at 31 December 2009 and as a percentage of closing loans and advances increased to 4.6 per cent from 1.8 per cent at 31 December 2009. Impairment charges increased by £26 million to £106 million compared to £80 million in 2009. Impairment charges as a percentage of average loans and advances to customers increased to 1.3 per cent from 1.0 per cent in 2009. The most significant contribution to the impairment charge is from a limited number of corporate exposures which at the year end comprised 82 per cent of impaired lending and 92 per cent of the impairment charge in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LOAN PORTFOLIO (unaudited)

ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

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

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Loans and advances to banks	**30,292**	35,510	38,868	34,845	40,639
Loans and advances to customers:					
Mortgages	**356,261**	362,667	114,643	102,739	95,601
Other personal lending	**36,967**	42,958	25,318	22,988	23,025
Agriculture, forestry and fishing	**5,558**	5,130	3,969	3,226	2,905
Energy and water supply	**3,576**	3,031	2,598	2,102	2,024
Manufacturing	**11,495**	14,912	12,057	8,385	7,513
Construction	**7,904**	10,830	3,016	2,871	2,332
Transport, distribution and hotels	**34,176**	31,820	14,664	11,573	10,490
Postal and telecommunications	**1,908**	1,662	1,060	946	831
Financial, business and other services	**59,363**	66,923	33,319	29,707	22,999
Property companies	**78,263**	83,820	23,318	17,576	12,896
Lease financing	**8,291**	9,307	4,546	4,686	4,802
Hire purchase	**7,208**	8,710	5,295	5,423	5,060
Total loans	**641,262**	677,280	282,671	247,067	231,117
Allowance for impairment losses	**(18,393)**	(14,950)	(3,594)	(2,408)	(2,194)
Total loans and advances net of allowance for impairment losses	**622,869**	662,330	279,077	244,659	228,923

The analysis of loans and advances as at 31 December 2010 and 2009 between domestic and international offices is as follows:

	2010			2009		
	Domestic £m	**Foreign £m**	**Total £m**	Domestic £m	Foreign £m	Total £m
Loans and advances to banks	**28,544**	**1,748**	**30,292**	29,475	6,035	35,510
Loans and advances to customers:						
Mortgages	**334,531**	**21,730**	**356,261**	344,151	18,516	362,667
Other personal lending	**34,610**	**2,357**	**36,967**	40,790	2,168	42,958
Agriculture, forestry and fishing	**5,429**	**129**	**5,558**	4,829	301	5,130
Energy and water supply	**1,583**	**1,993**	**3,576**	1,141	1,890	3,031
Manufacturing	**9,599**	**1,896**	**11,495**	11,480	3,432	14,912
Construction	**6,814**	**1,090**	**7,904**	6,554	4,276	10,830
Transport, distribution and hotels	**26,156**	**8,020**	**34,176**	22,713	9,107	31,820
Postal and telecommunications	**1,391**	**517**	**1,908**	973	689	1,662
Financial, business and other services	**49,931**	**9,432**	**59,363**	58,132	8,791	66,923
Property companies	**59,163**	**19,100**	**78,263**	64,069	19,751	83,820
Lease financing	**7,351**	**940**	**8,291**	8,426	881	9,307
Hire purchase	**6,319**	**889**	**7,208**	7,671	1,039	8,710
Total loans	**571,421**	**69,841**	**641,262**	600,404	76,876	677,280
Allowance for impairment losses	**(9,786)**	**(8,607)**	**(18,393)**	(9,995)	(4,955)	(14,950)

Total loans and advances net of allowance for impairment losses	**561,635**	**61,234**	**622,869**	590,409	71,921	662,330

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. During 2010, the Group has reviewed the detailed breakdown of movements in impairment allowances and some disclosures for the year ended 31 December 2009 have been reclassified to conform with the current year presentation.

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Balance at beginning of year	**14,950**	3,594	2,408	2,194	2,073
Exchange and other adjustments	**(7)**	112	43	2	(13)
Acquisition and disposal of businesses and portfolios					(27)
Advances written off:					
Loans and advances to customers:					
Mortgages	**(145)**	(77)	(23)	(25)	(9)
Other personal lending	**(3,344)**	(3,063)	(1,206)	(1,256)	(1,195)
Agriculture, forestry and fishing	**(47)**	(5)	(2)	(1)	(1)
Energy and water supply	**(36)**	(28)	(24)	(11)	(17)
Manufacturing	**(385)**	(148)	(34)	(13)	(24)
Construction	**(365)**	(336)	(11)	(4)	(7)
Transport, distribution and hotels	**(742)**	(80)	(50)	(24)	(50)
Postal and telecommunications		(9)			
Financial, business and other services	**(881)**	(308)	(169)	(95)	(142)
Property companies	**(846)**	(51)	(6)		(4)
Lease financing	**(15)**	(26)	(2)	(26)	(1)
Hire purchase	**(160)**	(69)	(59)	(87)	(39)
Loans and advances to banks	**(111)**				
Total advances written off	**(7,077)**	(4,200)	(1,586)	(1,542)	(1,489)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	**12**	1	1	2	2
Other personal lending	**176**	107	102	121	158
Energy and water supply	**4**				1
Manufacturing	**2**			1	3
Construction	**1**				1
Transport, distribution and hotels	**4**		1	1	4
Financial, business and other services	**1**	2	3	3	12
Property companies	**16**				
Hire purchase			5	9	9
Total recoveries of advances written off	**216**	110	112	137	190
Total net advances written off	**(6,861)**	(4,090)	(1,474)	(1,405)	(1,299)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2010 **£m**	2009 £m	2008 £m	2007 £m	2006 £m
Effect of unwinding of discount recognised through interest income	**(403)**	(446)	(102)	(104)	(100)
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	**196**	343	171	18	12
Other personal lending	**3,431**	4,314	1,455	1,313	1,349
Agriculture, forestry and fishing	**20**	29	2	4	1
Energy and water supply	**17**	105	35	18	4
Manufacturing	**203**	747	122	19	12
Construction	**463**	842	61	8	5
Transport, distribution and hotels	**800**	1,553	66	39	29
Postal and telecommunications	**32**	24			
Financial, business and other services	**1,293**	1,913	491	151	53
Property companies	**4,114**	5,418	73	1	
Lease financing	**57**	261	1	35	4
Hire purchase	**101**	234	107	116	91
Loans and advances to banks	**(13)**	(3)	135	(1)	
Total allowances for impairment losses charged against income for the year	**10,714**	15,780	2,719	1,721	1,560
Total balance at end of year	**18,393**	14,950	3,594	2,408	2,194
Ratio of net write-offs during the year to average loans outstanding during the year	**1.1%**	0.6%	0.6%	0.7%	0.7%

The Group s impairment allowances in respect of loans and advances to banks and customers increased by £3,443 million, or 23 per cent, from £14,950 million at 31 December 2009 to £18,393 million at 31 December 2010. This increase resulted from a charge to the income statement of £10,714 million partly offset by net advances written off of £6,861 million (advances written off of £7,077 million less recoveries of £216 million). Of the total charge to the income statement of £10,714 million, £5,184 million arose in the UK and £5,530 million related to the Group s international businesses, dominated by the credit losses suffered in Ireland and Australia following the particular deterioration in economic conditions in those countries. By category of lending, the most significant elements of the charge to the income statement were £3,431 million in respect of other personal lending and £4,114 million in respect of property companies. The charge in respect of other personal lending arose mainly in the Retail division and was lower than in 2009 following improved arrears experience as a result of the Group s focus on lending to existing customers combined with stable unemployment. The charge in respect of property lending arose mainly overseas and again reflects losses in Ireland and Australia where much of the Group s credit exposure is in the commercial property sectors. Of the net advances written off of £6,861 million, £5,751 million arose in the UK and £1,110 million overseas; by category of lending £3,168 million related to other personal lending, £880 million related to financial, business and other services and £846 million to property companies.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of movements in the allowance for impairment losses on loans and advances to banks and customers for the years ended 31 December 2010 and 2009 between domestic and international offices is as follows:

	2010			2009		
	Domestic £m	**Foreign £m**	**Total £m**	Domestic £m	Foreign £m	Total £m
Balance at beginning of year	**10,785**	**4,165**	**14,950**	3,575	19	3,594
Exchange and other adjustments	**42**	**(49)**	**(7)**	171	(59)	112
Advances written off:						
Loans and advances to customers:						
Mortgages	**(130)**	**(15)**	**(145)**	(77)		(77)
Other personal lending	**(3,322)**	**(22)**	**(3,344)**	(3,062)	(1)	(3,063)
Agriculture, forestry and fishing	**(8)**	**(39)**	**(47)**	(5)		(5)
Energy and water supply	**(16)**	**(20)**	**(36)**	(28)		(28)
Manufacturing	**(196)**	**(189)**	**(385)**	(147)	(1)	(148)
Construction	**(192)**	**(173)**	**(365)**	(336)		(336)
Transport, distribution and hotels	**(234)**	**(508)**	**(742)**	(80)		(80)
Postal and telecommunications				(9)		(9)
Financial, business and other services	**(827)**	**(54)**	**(881)**	(308)		(308)
Property companies	**(740)**	**(106)**	**(846)**	(51)		(51)
Lease financing	**(15)**		**(15)**	(25)	(1)	(26)
Hire purchase	**(160)**		**(160)**	(69)		(69)
Loans and advances to banks	**(111)**		**(111)**			
Total advances written off	**(5,951)**	**(1,126)**	**(7,077)**	(4,197)	(3)	(4,200)
Recoveries of advances written off:						
Loans and advances to customers:						
Mortgages	**12**		**12**	1		1
Other personal lending	**176**		**176**	107		107
Agriculture, forestry and fishing						
Energy and water supply		**4**	**4**			
Manufacturing		**2**	**2**			
Construction		**1**	**1**			
Transport, distribution and hotels		**4**	**4**			
Postal and telecommunications						
Financial, business and other services		**1**	**1**	1	1	2
Property companies	**12**	**4**	**16**			
Hire purchase						
Total recoveries of advances written off	**200**	**16**	**216**	109	1	110
Total net advances written off	**(5,751)**	**(1,110)**	**(6,861)**	(4,088)	(2)	(4,090)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2010			2009		
	Domestic £m	**Foreign £m**	**Total £m**	Domestic £m	Foreign £m	Total £m
Effect of unwinding of discount recognised through interest income	**(474)**	**71**	**(403)**	(446)		(446)
Allowances for impairment losses charged against income for the year:						
Loans and advances to customers:						
Mortgages	**(27)**	**223**	**196**	275	68	343
Other personal lending	**2,690**	**741**	**3,431**	3,714	600	4,314
Agriculture, forestry and fishing	**5**	**15**	**20**	2	27	29
Energy and water supply	**30**	**(13)**	**17**	24	81	105
Manufacturing	**78**	**125**	**203**	544	203	747
Construction	**318**	**145**	**463**	593	249	842
Transport, distribution and hotels	**217**	**583**	**800**	717	836	1,553
Postal and telecommunications	**31**	**1**	**32**	19	5	24
Financial, business and other services	**696**	**597**	**1,293**	1,670	243	1,913
Property companies	**1,059**	**3,055**	**4,114**	3,685	1,733	5,418
Lease financing	**26**	**31**	**57**	198	63	261
Hire purchase	**74**	**27**	**101**	135	99	234
Loans and advances to banks	**(13)**		**(13)**	(3)		(3)
Total allowances for impairment losses charged against income for the year	**5,184**	**5,530**	**10,714**	11,573	4,207	15,780
Total balance at end of year	**9,786**	**8,607**	**18,393**	10,785	4,165	14,950

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

	2010 Allowance £m	**2010 Percentage of loans in each category to total loans %**	2009 Allowance £m	2009 Percentage of loans in each category to total loans %	2008 Allowance £m	2008 Percentage of loans in each category to total loans %	2007 Allowance £m	2007 Percentage of loans in each category to total loans %	2006 Allowance £m	2006 Percentage of loans in each category to total loans %
Balance at year end applicable to:										
Loans and advances to banks	**20**	**4.7**	149	5.2	135	13.8		14.1	1	17.6
Loans and advances to customers:										
Mortgages	**526**	**55.5**	464	53.6	186	40.5	37	41.5	42	41.3
Other personal lending	**3,541**	**5.8**	3,419	6.3	2,047	9.0	1,795	9.3	1,720	9.9
Agriculture, forestry and fishing	**16**	**0.9**	33	0.8	5	1.4	5	1.3	2	1.3
Energy and water supply	**108**	**0.6**	120	0.4	33	0.9	22	0.9	14	0.9
Manufacturing	**540**	**1.8**	709	2.2	119	4.3	29	3.4	25	3.3
Construction	**588**	**1.2**	527	1.6	60	1.1	10	1.2	6	1.0

Transport, distribution and hotels	**1,400**	**5.3**	1,391	4.7	75	5.2	58	4.7	45	4.5
Postal and telecommunications	**50**	**0.3**	15	0.2		0.4		0.4		0.4
Financial, business and other services	**2,451**	**9.3**	2,108	9.9	596	11.7	232	12.0	166	9.9
Property companies	**8,546**	**12.2**	5,394	12.4	70	8.2	4	7.1	5	5.6
Lease financing	**287**	**1.3**	244	1.4	15	1.6	16	1.9	7	2.1
Hire purchase	**320**	**1.1**	377	1.3	253	1.9	200	2.2	161	2.2
Total balance at year end	**18,393**	**100.0**	14,950	100.0	3,594	100.0	2,408	100.0	2,194	100.0

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of the coverage of the allowance for loan losses at 31 December 2010 and 2009 between domestic and international offices is as follows:

	Domestic		Foreign		Total	
2010	**Allowance £m**	**Percentage of loans in each category to total loans %**	**Allowance £m**	**Percentage of loans in each category to total loans %**	**Allowance £m**	**Percentage of loans in each category to total loans %**
Balance at year end applicable to:						
Loans and advances to banks	**20**	**5.0**		**2.5**	**20**	**4.7**
Loans and advances to customers:						
Mortgages	**269**	**58.4**	**257**	**31.1**	**526**	**55.5**
Other personal lending	**2,212**	**6.1**	**1,329**	**3.4**	**3,541**	**5.8**
Agriculture, forestry and fishing	**16**	**1.0**		**0.2**	**16**	**0.9**
Energy and water supply	**55**	**0.3**	**53**	**2.9**	**108**	**0.6**
Manufacturing	**385**	**1.7**	**155**	**2.7**	**540**	**1.8**
Construction	**364**	**1.2**	**224**	**1.6**	**588**	**1.2**
Transport, distribution and hotels	**546**	**4.6**	**854**	**11.5**	**1,400**	**5.3**
Postal and telecommunications	**50**	**0.2**		**0.7**	**50**	**0.3**
Financial, business and other services	**1,630**	**8.7**	**821**	**13.5**	**2,451**	**9.3**
Property companies	**3,844**	**10.4**	**4,702**	**27.3**	**8,546**	**12.2**
Lease financing	**189**	**1.3**	**98**	**1.3**	**287**	**1.3**
Hire purchase	**206**	**1.1**	**114**	**1.3**	**320**	**1.1**
Total	**9,786**	**100.0**	**8,607**	**100.0**	**18,393**	**100.0**

	Domestic		Foreign		Total	
2009	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %
Balance at year end applicable to:						
Loans and advances to banks	149	4.9		7.9	149	5.2
Loans and advances to customers:						
Mortgages	398	57.2	66	24.0	464	53.6
Other personal lending	2,822	6.8	597	2.8	3,419	6.3
Agriculture, forestry and fishing	6	0.8	27	0.4	33	0.8
Energy and water supply	42	0.2	78	2.5	120	0.4
Manufacturing	504	1.9	205	4.5	709	2.2
Construction	277	1.1	250	5.6	527	1.6
	606	3.8	785	11.8	1,391	4.7

Transport, distribution and hotels						
Postal and telecommunications	10	0.2	5	0.9	15	0.2
Financial, business and other services	1,842	9.7	266	11.4	2,108	9.9
Property companies	3,666	10.7	1,728	25.7	5,394	12.4
Lease financing	182	1.4	62	1.1	244	1.4
Hire purchase	281	1.3	96	1.4	377	1.3
Total	10,785	100.0	4,165	100.0	14,950	100.0

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK ELEMENTS IN THE LOAN PORTFOLIO (unaudited)

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.

		Loans and advances to customers				
	Loans and advances to banks £m	Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2010						
Neither past due nor impaired	**30,259**	**339,509**	**45,058**	**159,274**	**547,841**	**12,545**
Past due but not impaired		**13,215**	**1,289**	**3,427**	**17,931**	
Impaired no provision required		**2,189**	**433**	**5,313**	**7,935**	
provision held	**20**	**5,591**	**5,149**	**45,931**	**56,671**	
Gross	**30,279**	**360,504**	**51,929**	**213,945**	**626,378**	**12,545**
31 December 2009						
Neither past due nor impaired	35,333	347,292	48,429	185,872	581,593	19,082
Past due but not impaired		12,587	1,873	5,118	19,578	
Impaired no provision required		2,034	449	6,603	9,086	
provision held	153	5,918	5,902	37,927	49,747	
Gross	35,486	367,831	56,653	235,520	660,004	19,082
31 December 2008						
Neither past due nor impaired	38,716	110,148	33,571	86,707	230,426	608
Past due but not impaired	17	3,134	1,146	555	4,835	
Impaired no provision required		479	150	1,253	1,882	
provision held	135	882	4,327	1,451	6,660	
Gross	38,868	114,643	39,194	89,966	243,803	608
31 December 2007						
Neither past due nor impaired	34,845	99,828	29,850	73,475	203,153	1,189

Past due but not impaired			2,153	966	639	3,758	
Impaired	no provision required		415	100	293	808	
	provision held		343	3,600	560	4,503	
Gross		34,845	102,739	34,516	74,967	212,222	1,189
31 December 2006							
Neither past due nor impaired		40,638	92,873	29,364	60,005	182,242	835
Past due but not impaired			1,943	1,005	374	3,322	
Impaired	no provision required		658	92	158	908	
	provision held	1	127	3,580	299	4,006	
Gross		40,639	95,601	34,041	60,836	190,478	835

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Loans and advances to banks £m	Loans and advances to customers: Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2010						
0-30 days		**6,498**	**1,004**	**1,331**	**8,833**	
30-60 days		**2,674**	**246**	**498**	**3,418**	
60-90 days		**1,811**	**29**	**394**	**2,234**	
90-180 days		**2,223**	**10**	**337**	**2,570**	
Over 180 days		**9**		**867**	**876**	
Total		**13,215**	**1,289**	**3,427**	**17,931**	
31 December 2009						
0-30 days		6,018	1,316	2,347	9,681	
30-60 days		2,649	376	825	3,850	
60-90 days		1,702	74	825	2,601	
90-180 days		2,216	48	560	2,824	
Over 180 days		2	59	561	622	
Total		12,587	1,873	5,118	19,578	
31 December 2008						
0-30 days		1,527	853	289	2,669	
30-60 days		633	259	90	982	
60-90 days	17	424	32	70	526	
90-180 days		549	2	77	628	
Over 180 days		1		29	30	
Total	17	3,134	1,146	555	4,835	
31 December 2007						
0-30 days		1,123	781	266	2,170	
30-60 days		445	155	107	707	
60-90 days		260	29	129	418	
90-180 days		325	1	67	393	
Over 180 days				70	70	
Total		2,153	966	639	3,758	
31 December 2006						
0-30 days		1,104	797	156	2,057	
30-60 days		341	182	60	583	
60-90 days		216	26	38	280	
90-180 days		280		70	350	
Over 180 days		2		50	52	
Total		1,943	1,005	374	3,322	

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

POTENTIAL PROBLEM LOANS

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

		Loans and advances to customers				Loans and advances designated at fair value through profit or loss
	Loans and advances to banks £m	Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	£m
31 December 2010						
Good quality	**29,835**	**332,614**	**30,076**	**57,552**		**12,220**
Satisfactory quality	**265**	**5,259**	**11,084**	**42,906**		**163**
Lower quality	**16**	**834**	**1,170**	**45,750**		**83**
Below standard, but not impaired	**143**	**802**	**2,728**	**13,066**		**79**
Total	**30,259**	**339,509**	**45,058**	**159,274**	**543,841**	**12,545**
31 December 2009						
Good quality	34,434	335,482	30,743	61,810		18,702
Satisfactory quality	135	9,614	12,654	59,752		267
Lower quality	15	746	1,480	45,986		90
Below standard, but not impaired	749	1,450	3,552	18,324		23
Total	35,333	347,292	48,429	185,872	581,593	19,082
31 December 2008						
Good quality	38,283	109,815	21,373	49,349		129
Satisfactory quality	215	264	9,192	31,042		411
Lower quality	204		900	5,831		56
Below standard, but not impaired	14	69	2,106	485		12
Total	38,716	110,148	33,571	86,707	230,426	608
31 December 2007						
Good quality	34,647	99,407	18,157	46,240		191
Satisfactory quality	190	378	8,964	25,013		670
Lower quality	7	1	665	2,034		327
Below standard, but not impaired	1	42	2,064	188		1
Total	34,845	99,828	29,850	73,475	203,153	1,189
31 December 2006						
Good quality	40,418	92,472	16,940	35,659		513
Satisfactory quality	201	359	9,667	21,797		314
Lower quality	17		663	2,249		3
Below standard, but not impaired	2	42	2,094	300		5
Total	40,638	92,873	29,364	60,005	182,242	835

For further details see pages F-108 to F-112.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

	2010 £m
Interest income that would have been recognised under original contract terms	**2,484**
Interest income included in profit	**(1,288)**
Interest foregone	**1,196**

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.

IFRS 7 requires the disclosure of loans that were renegotiated during the year and that would otherwise have been past due or impaired at the year end (2010: £5,475 million; 2009: £3,919 million; 2008: £144 million; 2007: £579 million; 2006: £342 million); see also page F-111.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The £5,475 million of lending in 2010 was renegotiated for the following reasons:

	£m
Capitalisation of arrears	**2,804**
Interest rate adjustment	**337**
Payment holidays	**221**
Interest capitalisation	**10**
Forbearance of principal	**2,103**
Total	**5,475**

FORBEARANCE

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

Customers can have their arrears balance recapitalised once they have demonstrated they can pay the original contractual minimum payment, but are unable to clear their arrears. This is usually demonstrated by the customer making six consecutive contractual monthly payments. Customers are not however able to recapitalise more than twice in a five year period. Recapitalised mortgages will return to the non-impaired book and will be managed in accordance with the recapitalised terms of the mortgage.

ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES

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

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

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

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

CROSS BORDER OUTSTANDINGS

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

	% of assets	Total £m	Governments and official	Banks and other	Commercial, industrial

			institutions £m	financial institutions £m	and other £m
As at 31 December 2010:					
United States of America	**4.1**	**40,246**	**8,304**	**12,022**	**19,920**
Germany	**1.4**	**14,156**	**2,488**	**6,715**	**4,953**
France	**1.1**	**10,708**	**1,409**	**4,368**	**4,931**
As at 31 December 2009:					
United States of America	1.9	19,033	3,266	2,548	13,219
France	1.4	14,126	768	2,932	10,426
As at 31 December 2008:					
United States of America	2.0	8,928	253	1,843	6,832
France	1.1	4,735	69	2,904	1,762
Netherlands	1.0	4,449	4	1,658	2,787

As at 31 December 2010, United States of America had commitments of £21,203 million, Germany had commitments of £7,500 million and France had commitments of £5,199 million.

As at 31 December 2010 the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £15,714 million in total were Australia and the Netherlands.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MARKET RISK (audited)

DEFINITION

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

RISK APPETITE

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

This statement of the Group s overall appetite for market risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. Individual members of the Group Executive Committee ensure that market risk appetite is further delegated to an appropriate level within their areas of responsibility.

EXPOSURES

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

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

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

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

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

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

- With Profit Funds are managed with the aim of generating rates of return consistent with policyholders expectations and this involves the mismatch of assets and liabilities.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in Force see note 30 to the financial statements.)
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in four portfolios: (a) in the long term funds of Scottish Widows plc, Clerical Medical Investment Group Limited and their subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group s defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 43 to the financial statements.

MEASUREMENT

The following market risk measures are used for risk reporting and setting risk appetite limits and triggers:

Value at Risk: for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used

Standard Stresses: Interest Rates 25 basis points; Equities 10 per cent; Credit Spreads relative 30 per cent widening

Bespoke Extreme Stress Scenarios: e.g. stock market crash

Both VaR and standard stress measures are also used in setting divisional market risk appetite limits and triggers.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures. Trading book VaR (1-day 99 per cent) is back-tested daily against profit and loss.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

BANKING TRADING ASSETS AND OTHER TREASURY POSITIONS

Based on the commonly used 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2010 and 2009 based on the Group s global trading positions was as detailed in the table entitled Banking trading assets and other treasury positions.

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the five risk types, which now includes inflation. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity.

BANKING TRADING ASSETS AND OTHER TREASURY POSITIONS

As at 31 December	**2010**				2009
	Close £m	**Average £m**	**Maximum £m**	**Minimum £m**	Close restated £m
Interest rate risk	**3.9**	**4.4**	**8.0**	**2.3**	7.1
Foreign exchange risk	**0.4**	**0.4**	**0.8**	**0.1**	1.1
Equity risk			**0.2**		
Credit spread risk	**1.6**	**2.4**	**4.3**	**1.2**	4.1
Inflation risk	**0.3**	**0.2**	**0.7**		0.2
Total VaR	**6.2**	**7.4**	**13.0**	**4.2**	12.5

2009 VaR has been restated to reflect trading risk only. Risk relating to the funding of the lending business is reported in the Banking-Non-Trading section of the report.

BANKING NON-TRADING

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

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

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

The following table shows, split by material currency, Lloyds Banking Group sensitivities as at 31 December 2010 to an immediate up and down 25 basis points change to all interest rates.

BANKING NON-TRADING

	2010		2009	
	Up 25bps £m	**Down 25bps £m**	Up 25bps £m	Down 25bps £m

Sterling	**(86.9)**	**88.4**	66.6	(66.4)
US Dollar	**11.1**	**(11.4)**	(5.5)	5.6
Euro	**8.9**	**(9.0)**	4.4	(4.4)
Australian Dollar	**(1.2)**	**1.2**	2.2	(2.3)
Other	**(3.0)**	**3.1**	(0.2)	0.2
	(71.1)	**72.3**	67.5	(67.3)

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

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

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

PENSION SCHEMES

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

The schemes main exposures are to equity risk, real rate risk and credit spread risk. Accounting for the pension schemes under International Accounting Standard (IAS)19 spreads any adverse impacts of these risks over time.

INSURANCE PORTFOLIOS

The Group s market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2010 and 2009. Foreign exchange risk arises predominantly from overseas holdings of equities. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE PORTFOLIOS

As at 31 December	2010 £m	2009 £m
Equity risk (impact of 10 per cent fall pre-tax)	**(367.4)**	(383.6)
Interest rate risk (impact of 25 basis point reduction pre-tax)	**82.1**	64.0
Credit spread risk (impact of relative 30 per cent widening)	**(163.0)**	(156.4)

MITIGATION

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

BANKING NON-TRADING ACTIVITIES

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

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

INSURANCE ACTIVITIES

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

MONITORING

The Senior Asset and Liability Committee and the Group Market Risk Forum regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by Group Risk. Where appropriate, escalation procedures are in place.

BANKING ACTIVITIES

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

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

INSURANCE ACTIVITIES

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group s overall risk appetite and regularly reviewed by the Senior Asset and Liability Committee and the Group Market Risk Forums:

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

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

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

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

INSURANCE RISK (audited)

DEFINITION

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

RISK APPETITE

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

The Group s appetite for insurance risk is reviewed and approved annually by the Board.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EXPOSURES

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

MEASUREMENT

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

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate, for example those set out in note 39 to the financial statements.

MITIGATION

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level Committees/Boards. For the life assurance businesses the key control bodies are the Board of Scottish Widows Group Limited and the Board of HBOS Financial Services Limited with the more significant risks also being subject to review by the Group Executive Committee and/or the Lloyds Banking Group Board. For the general insurance businesses the key control bodies are the Boards of the legal entities including Lloyds TSB General Insurance Limited, St. Andrew s Insurance plc and the Irish subsidiaries, with the more significant risks again being subject to Group Executive Committee and/or Lloyds Banking Group Board review. All Group staff pension schemes issues are covered by the Group Asset and Liability Committee and the Group Business Risk Committee.

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

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products)
- Claims management
- Product design
- Policy wording
- Product management
- The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

The most significant insurance risks in the life assurance companies are longevity risk and persistency risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed. By their nature persistency risks are difficult to hedge.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present.

In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees to assist with the management of risk in line with the Group s risk appetite.

MONITORING

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk. Reasons for any significant divergence from experience are investigated and remedial action is taken.

Insurance risk exposures are reported and monitored regularly by the Group Executive Committee.

OPERATIONAL RISK (unaudited)

DEFINITION

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, operational inefficiencies, or from people related or external events.

There are a number of categories of operational risk:

LEGAL AND REGULATORY

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

CUSTOMER TREATMENT

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate or poor customer treatment.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PEOPLE

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

SUPPLIER MANAGEMENT

The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third-party suppliers.

CUSTOMER PROCESSES

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor externally facing business processes. Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and/or system failure.

FINANCIAL CRIME

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related legal and regulatory obligations, these losses may include censure, fines or the cost of litigation.

MONEY LAUNDERING AND SANCTIONS

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with failure to comply with prevailing legal and regulatory obligations on activities related to money laundering, sanctions and counter terrorism, these losses may include censure, fines or the cost of litigation.

SECURITY

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group s assets, the loss, corruption, misuse or theft of the Group s information assets or threats or actual harm to the Group s people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

IT SYSTEMS

The risk of reductions in earnings and/or value through financial or reputational loss resulting from the development, delivery and maintenance of effective IT solutions.

CHANGE

The risk of reductions in earnings and/or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

ORGANISATIONAL INFRASTRUCTURE

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor internally facing business processes at group, divisional or business unit level. Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

RISK APPETITE

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group s reputation.

The Group encourages and maintains an appropriately balanced legal and regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

EXPOSURES

By its very nature, operational risks can arise from a wide range of the Group s activities that involve people, processes and systems. The Group s principal operational risks relate to the Group s ability to attract, retain and motivate its people, the rate and scale of change arising from the Group s integration programme, the way in which the Group treats its customers and the legal and regulatory environment in which it operates.

The Group continues to face risks relating to its ability to attract, retain, and develop high calibre talent, as a result of challenges arising from ongoing regulatory and public interest in remuneration practices, delivery of the Group s integration commitments; and uncertainty from EU state aid requirements and Independent Commission on Banking proposals on banking reform.

The integration programme continues to be one of the largest integration exercises undertaken by a financial services firm. The breadth of the integration programme is such that all parts of the Group are impacted to a large or small degree, with the greatest impact being on the Retail bank. Although now over two years into the successful implementation of the programme, there continue to be delivery risks as the programme moves into its final phase of execution.

Customer treatment and how the Group manages its customer relationships affects all aspects of the Group s operations and is closely aligned with achievement of the Group s strategic aim to create deep long lasting relationships with its customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies, which includes, for example PPI (see note 54 to the financial statements Contingent Liabilities and Commitments).

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MEASUREMENT

Both Lloyds TSB and HBOS had operational risk Advanced Measurement Approach Waivers, granted by the FSA, enabling the use of an internal capital model for calculating regulatory capital. As part of its integration programme, Lloyds Banking Group is in the process of moving to The Standardised Approach (TSA) and, in anticipation of this, calculated regulatory capital for the year ended 31 December 2010 on the basis of TSA.

MITIGATION

The Group s operational risk management framework consists of the following key components:

- Identification and categorisation of the key operational risks facing a business area.
- Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed.
- Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed.
- Loss and incident management, capturing actions to manage any losses facing a business area.
- The development of Key Risk Indicators for management reporting.
- Oversight and assurance of the risk management framework in divisions and businesses.
- Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

MONITORING

Business unit risk exposure is aggregated at divisional level and reported to Group Risk where a group-wide report is prepared. The report is discussed at the monthly Group Operational and Regulatory Risk Committee. This committee can escalate matters to the Chief Risk Officer, or higher committees if appropriate.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group s senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

FINANCIAL SOUNDNESS (audited)

Financial soundness risk has three key risk components covering liquidity and funding risk; capital risk; and financial and prudential regulatory reporting, disclosure and tax risk.

LIQUIDITY AND FUNDING RISK

DEFINITION (audited)

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost. Funding risk is further defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

RISK APPETITE (audited)

Liquidity and funding risk appetite for the banking businesses is set by the Board and reviewed on an annual basis. This statement of the Group s overall appetite for liquidity risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. It is reported through various metrics that enable the Group to manage liquidity and funding constraints. The Group Chief Executive, assisted by the Group Asset and Liability Committee and its sub-committee the Senior Asset and Liability Committee, regularly reviews performance against risk appetite.

EXPOSURE (audited)

Liquidity exposure represents the amount of potential outflows in any future period less committed inflows. Liquidity is considered from both an internal and regulatory perspective.

MEASUREMENT (audited)

A series of measures are used across the Group to monitor both short and long term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. The Board approved liquidity risk appetite links a number of these measures to balance sheet progression set out in the group funding plan, with regular reporting to the Board. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Note 56(4) to the financial statements sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group s assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. This forms the foundation of the Group s liquidity controls.

MITIGATION (audited)

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group s strategic liquidity profile which is determined by the Group s balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group s funding and liquidity position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term funding. A substantial proportion of the retail deposit base is made up of customers current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group s short-term money market funding is based on a qualitative analysis of the market s capacity for the Group s credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to corporate customers to supplement its retail deposit base.

The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group s banking businesses. The Group holds sizeable balances of high grade marketable debt securities as set out in the table entitled Group funding by type which can be sold to provide, or used to secure, additional short term funding should the need arise from either market counterparties or central bank facilities (European Central Bank, Federal Reserve, Bank of England and Reserve Bank of Australia).

MONITORING (audited)

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group s committee structure, in particular the Group Asset and Liability Committee and the Senior Asset and Liability Committee which meet monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent oversight.

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components:

Firstly, the Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both Lloyds Banking Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.

Secondly, the Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group has invested considerable resource to ensure that it satisfies the governance, reporting and stress testing requirements of the FSA s new ILAS liquidity regime. The Group has noted the industry move towards strategic balance sheet measures of the funding profile and has started to monitor and forecast the Group s Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR). The Group is aware that the regulatory liquidity landscape is subject to potential change. Specifically, in relation to the papers issued by the Basel Committee on Banking Supervision (Strengthening the resilience of the banking sector and International framework for liquidity risk measurement, standards and monitoring) the Group has actively participated in the industry-wide consultation and calibration exercises which took place through 2010.

During the year, the individual entities within the Group, and the Group, complied with all of the externally imposed liquidity and funding requirements to which they are subject.

LIQUIDITY AND FUNDING MANAGEMENT IN 2010 (unaudited)

During 2010 liquidity and funding remained a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and liquidity where necessary, its ability to fund its financial obligations could be affected.

The Group is reliant on both wholesale funding markets and the legacy Government and central bank facilities to support its balance sheet. The liquidity and funding challenges facing the Group over the medium term continue to be ensuring sustainable access to wholesale funding markets, and the repayment of Government and central bank facilities. The combination of a clear focus on right-sizing the balance sheet, continued development of the Group s customer deposit base, and strategic access to the capital markets will enable the Group to strengthen its funding base while reducing its overall wholesale funding requirement.

The key dependencies on successfully funding the Group s balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the Group s balance sheet; the repayment of Government and central bank facilities in accordance with the agreed terms; no more than limited further deterioration in the UK s and the Group s credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on wholesale funding markets. Additionally, the Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

During 2010, the Group further improved the diversification of funding supporting its balance sheet. Wholesale funding reduced by £27.5 billion whilst customer deposits increased by £11.3 billion, resulting in a more stable liability base. The customer loan to deposit ratio improved to 154 per cent compared with 169 per cent at 31 December 2009.

At 31 December 2010, the Group s further overall support from legacy Government and central bank facilities totalled £96.6 billion, a reduction of £60.6 billion compared with 31 December 2009. These facilities have various maturity dates, the last of which is in the fourth quarter of 2012. The Group s plan to right size the balance sheet is expected to avoid the necessity to refinance much of this. Repayment of the remaining amount will be achieved by a combination of customer deposit growth and term wholesale issuance.

ANALYSIS OF GOVERNMENT AND CENTRAL BANK FACILITIES (audited)

As at 31 December	**2010 £bn**	2009 £bn
Credit Guarantee Scheme	**45.4**	50.0
Other	**51.2**	107.2
Total Government and central bank facilities	**96.6**	157.2

The Group s wholesale term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total funding) at 31 December 2010 has been maintained at 50 per cent.

Despite the market disruption as a result of European sovereign risk concerns during 2010, the Group outperformed its term wholesale issuance plans, allowing an accelerated repayment of Government and central bank facilities and thus reducing the on-going reliance on short term funding. The Group continued to fund itself successfully in the short term money markets, extending the maturity profile of this source of funding. The Group anticipates that wholesale markets will remain vulnerable to periods of disruption during 2011. To mitigate the impact of such events, the Group has been actively diversifying its funding sources and investor base.

In June 2010, the FSA introduced a new liquidity framework (Individual Liquidity Adequacy Standards ILAS) bringing in enhanced systems and controls, quantitative requirements, reporting requirements and stress testing. As part of the ILAS framework, the FSA has issued an Individual Liquidity Guidance (ILG) to the Group, representing a new regulatory requirement, which was effective from 1 June 2010. The Group has maintained its liquidity levels above the ILG regulatory minimum since inception.

Late in 2010, the Basel Committee on Banking Supervision refined the details of the Basel III reforms to ensure the strengthening of global liquidity standards. This supplemented the 2008 published Principles of Sound Liquidity Risk Management and Supervision (Sound Principles). These principles have been strengthened by the development of two principal liquidity measures.

The first measure promotes short term resilience of the liquidity profile by ensuring that banks have sufficient high quality liquid assets to meet potential funding outflows in a stressed environment within a one month period. This is measured by the LCR. The second promotes resilience over a longer time horizon by requiring banks to fund their activities with a more stable source of funding on a going concern basis. This is measured by NSFR which has a time horizon of one year and has been developed to ensure a sustainable maturity structure of assets and liabilities.

The Group welcomes the Basel Committee s Sound Principles. The introduction of the LCR (January 2015) and NSFR (January 2018) will raise the resilience of banks to potential liquidity shocks and provide the basis for a harmonised approach to liquidity risk management. At 31 December 2010, the Group s internal calculation of the LCR was 71 per cent and the NSFR was 88 per cent; the guidance issued by the Basel Committee is still subject to final ratification by the EU and the methodology is likely to be refined on the basis of feedback from banks and regulators during the observation period. The actions already announced to right size the balance sheet are expected to ensure compliance with the future minimum standards, which are expected to be 100 per cent for both ratios by their respective effective dates.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GROUP FUNDING POSITION (audited)

As at 31 December	**2010 £bn**	2009 £bn	Change %
Funding requirement			
Loans and advances to customers[1]	**589.5**	625.9	(6)
Loans and advances to banks[2]	**10.5**	16.1	(35)
Debt securities	**25.7**	32.7	(21)
Available-for-sale financial assets secondary[3]	**25.7**	37.7	(32)
Cash balances[4]	**3.6**	2.7	33
Funded assets	**655.0**	715.1	(8)
On balance sheet primary liquidity assets[5]			
Reverse repurchase agreements	**7.3**	5.3	38
Balances at central banks primary[4]	**34.5**	36.3	(5)
Available-for-sale financial assets primary	**17.3**	8.9	94
Held to maturity	**7.9**		
	67.0	50.5	33
Other assets[6]	**269.6**	261.7	3
Total Group assets	**991.6**	1,027.3	(3)
Less: Other liabilities[6]	**(229.1)**	(223.4)	3
Funding requirement	**762.5**	803.9	(5)
Funded by			
Customer deposits[7]			