Lloyds Banking Group plc
Form 424B2
October 02, 2018

The information in this preliminary prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been filed with the Securities and Exchange Commission and has become effective. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell nor are they soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Filed pursuant to Rule 424(b)(2)

Registration No. 333-211791

Subject to Completion

Preliminary Prospectus Supplement dated October 2, 2018

PRELIMINARY PROSPECTUS SUPPLEMENT
(to prospectus dated June 2, 2016)

Lloyds Banking Group plc

$ Fixed Rate Reset Additional Tier 1 Perpetual Subordinated Contingent Convertible Securities

(Callable September 27, 2025 and Every Five Years Thereafter)

The $ fixed rate reset additional tier 1 perpetual subordinated contingent convertible securities (callable September 27, 2025 and every five years thereafter) (the "Additional Tier 1 Securities") are perpetual securities with no maturity date. From and including October , 2018 (the "Issue Date") to but excluding September 27, 2025 (the "First Call Date"), interest will accrue on the Additional Tier 1 Securities at an initial rate equal to % per annum. The First Call Date and every 5th anniversary thereafter shall be a "Reset Date". From and including each Reset Date to but excluding the next succeeding Reset Date, interest will accrue on the Additional Tier 1 Securities at a rate per annum equal to the sum of the then-prevailing Mid-Market Swap Rate on the relevant Reset Determination Date and %, such sum being converted to a quarterly rate in accordance with market convention (rounded to three decimal places, with 0.0005 rounded down). Subject to the conditions as described further below, we will pay interest,

if any, quarterly in arrear (with a short first interest period) on March 27, June 27, September 27 and December 27 of each year, commencing on December 27, 2018 (each, an “Interest Payment Date”). The regular record dates for the Additional Tier 1 Securities will be the 15th calendar day preceding each Interest Payment Date, whether or not such day is a Business Day (each, a “Record Date”).

We may redeem the Additional Tier 1 Securities in whole, but not in part, at 100% of their principal amount, together with any accrued and unpaid interest on the Additional Tier 1 Securities, excluding any interest which has been canceled or deemed to be canceled in accordance with the terms of the Additional Tier 1 Securities, to, but excluding, the date fixed for redemption, (i) upon the occurrence of certain tax events or (ii) upon the occurrence of certain regulatory events, subject, in each case, to the conditions described in this prospectus supplement. The Additional Tier 1 Securities will also be redeemable in whole, but not in part, at our option and in our sole discretion on the First Call Date or on any Reset Date thereafter at 100% of their principal amount, together with any accrued and unpaid interest on the Additional Tier 1 Securities, excluding any interest which has been canceled or deemed to be canceled in accordance with the terms of the Additional Tier 1 Securities, to, but excluding, the date fixed for redemption. Any such redemption shall, among other requirements, be subject to the receipt of permission from the Relevant Regulator, as described in this prospectus supplement.

The Additional Tier 1 Securities will constitute our direct, unsecured and subordinated obligations, ranking *pari passu* without any preference among themselves. The rights and claims of the holders and beneficial owners in respect of, or arising from, the Additional Tier 1 Securities (including any damages, if payable) will be subordinated to the claims of our Senior Creditors (as defined herein, and includes certain claims in respect of subordinated liabilities).

The Additional Tier 1 Securities are not intended to be sold and should not be sold to retail investors in the European Economic Area, as defined in the rules set out in the Product Intervention (Contingent Convertible Instruments and Mutual Society Shares) Instrument 2015, as amended or replaced from time to time. Prospective investors are referred to the section headed “*Important Information—Prohibition on marketing and sales to retail investors*” commencing on page S-3 of this prospectus supplement.

Singapore Securities and Futures Act Product Classification—Solely for the purposes of its obligations pursuant to Sections 309B(1)(a) and 309B(1)(c) of the Securities and Futures Act (Chapter 289 of Singapore) (the “SFA”), we have determined, and hereby notify all relevant persons (as defined in Section 309A of the SFA) that the Additional Tier 1 Securities are “prescribed capital markets products” (as defined in the Securities and Futures (Capital Markets Products) Regulations 2018) and “Excluded Investment Products” (as defined in MAS Notice SFA 04-N12: Notice on the Sale of Investment Products and MAS Notice FAA-N16: Notice on Recommendations on Investment Products).

As described in this prospectus supplement, upon the occurrence of a Trigger Event (as defined herein), an Automatic Conversion (as defined herein) will occur and all of our obligations under the Additional Tier 1 Securities shall be irrevocably and automatically released in consideration of our issuance and delivery of the Settlement Shares (as defined herein).

Notwithstanding any other agreements, arrangements, or understandings between us and any holder or beneficial owner of the Additional Tier 1 Securities, by purchasing or acquiring the Additional Tier 1 Securities, each holder (including each beneficial owner) of the Additional Tier 1 Securities acknowledges, accepts, agrees to be bound by and consents to the exercise of any U.K. bail-in power (as defined below) by the relevant U.K. resolution authority that may result in (i) the reduction or cancellation of all, or a portion, of the principal amount of, or interest

on, the Additional Tier 1 Securities; (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Additional Tier 1 Securities into shares or other securities or other obligations of LBG (as defined herein) or another person; and/or (iii) the amendment or alteration of the maturity of the Additional Tier 1 Securities, or amendment of the amount of interest due on the Additional Tier 1 Securities, or the dates on which interest becomes payable, including by suspending payment for a temporary period; any U.K. bail-in power may be exercised by means of variation of the terms of the Additional Tier 1 Securities solely to give effect to the exercise by the relevant U.K. resolution authority of such U.K. bail-in power. With respect to (i), (ii) and (iii) above, references to principal and interest shall include payments of principal and interest that have become due and payable (including principal that has become due and payable at the maturity date), but which have not been paid, prior to the exercise of any U.K. bail-in power. Each holder and each beneficial owner of the Additional Tier 1 Securities further acknowledges and agrees that the rights of the holders and/or beneficial owners under the Additional Tier 1 Securities are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority.

For these purposes, a "U.K. bail-in power" is any write-down and/or conversion power existing from time to time under any laws, regulations, rules or requirements relating to the resolution of banks, banking group companies, credit institutions and/or investment firms incorporated in the United Kingdom in effect and applicable in the United Kingdom to us and the Group (as defined herein), including but not limited to any such laws, regulations, rules or requirements which are implemented, adopted or enacted within the context of a European Union directive or regulation of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and/or within the context of a U.K. resolution regime under the Banking Act as the same has been or may be amended from time to time (whether pursuant to the Banking Reform Act 2013, secondary legislation or otherwise), pursuant to which obligations of a bank, banking group company, credit institution or investment firm or any of its affiliates can be reduced, canceled, amended, transferred and/or converted into shares or other securities or obligations of the obligor or any other person (and a reference to the "relevant U.K. resolution authority" is to any authority with the ability to exercise a U.K. bail-in power).

By its acquisition of the Additional Tier 1 Securities, each holder and each beneficial owner of the Additional Tier 1 Securities, to the extent permitted by the Trust Indenture Act of 1939, as amended (the "TIA"), waives any and all claims against the Trustee (as defined herein) for, agrees not to initiate a suit against the Trustee in respect of, and agrees that the Trustee shall not be liable for, any action that the Trustee takes, or abstains from taking, in either case in accordance with the exercise of the U.K. bail-in power by the relevant U.K. resolution authority with respect to the Additional Tier 1 Securities.

Application will be made to The Irish Stock Exchange plc trading as Euronext Dublin ("Euronext Dublin") for the Additional Tier 1 Securities to be admitted to the Official List and to trading on the Global Exchange Market (the "Global Exchange Market"), which is the exchange regulated market of Euronext Dublin. Admission to the Official List and trading on the Global Exchange Market is expected to begin after the initial delivery of the Additional Tier 1 Securities.

The Additional Tier 1 Securities are not deposit liabilities of LBG and are not covered by the United Kingdom Financial Services Compensation Scheme or insured by the US Federal Deposit Insurance Corporation or any other governmental agency of the United Kingdom, the United States or any other jurisdiction.

Investing in the Additional Tier 1 Securities involves risks. See "Risk Factors" beginning on page S-20 of this prospectus supplement and as incorporated by reference herein.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.

	Price to Public	Underwriting Discount	Proceeds to us (before expenses)
Per Additional Tier 1 Security	%	%	%
Total	$	$	$

The initial public offering price set forth above does not include accrued interest, if any. Interest on the Additional Tier 1 Securities will accrue from the date of issuance, which is expected to be October , 2018. See "*Underwriting*".

We may use this prospectus supplement and the accompanying prospectus in the initial sale of the Additional Tier 1 Securities. In addition, Lloyds Securities Inc. or another of our affiliates may use this prospectus supplement and the accompanying prospectus in a market-making transaction in the Additional Tier 1 Securities after their initial sale. In connection with any use of this prospectus supplement and the accompanying prospectus by Lloyds Securities Inc. or another of our affiliates, unless we or our agent informs you otherwise in your confirmation of sale, you may assume this prospectus supplement and the accompanying prospectus is being used in a market-making transaction.

The Additional Tier 1 Securities will be issued in fully registered form in denominations of $200,000 and in integral multiples of $1,000 thereafter. We expect that the Additional Tier 1 Securities will be ready for delivery through the book-entry facilities of The Depository Trust Company and its participants including Clearstream Banking, S.A. ("Clearstream Luxembourg") and Euroclear Bank SA/NV ("Euroclear") on or about October , 2018.

Joint Bookrunning Managers

BNP PARIBAS Citigroup Goldman Sachs & Co. LLC HSBC Lloyds Securities

Prospectus Supplement dated October , 2018

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You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus (including any free writing prospectus issued or authorized by us). Neither we nor the underwriters have authorized anyone to provide you with different information. Neither we nor the underwriters are making an offer of these securities in any state or jurisdiction where the offer is not permitted. You should assume that the information contained in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference is accurate only as of their respective dates.

ABOUT THIS PROSPECTUS SUPPLEMENT

In this prospectus supplement, we use the following terms:

- “we”, “us”, “our” and “LBG” mean Lloyds Banking Group plc;
- “Group” means Lloyds Banking Group plc together with its subsidiaries and associated undertakings;
- “SEC” refers to the Securities and Exchange Commission;
- “pounds sterling”, “£” and “p” refer to the currency of the United Kingdom;
- “dollars” and “$” refer to the currency of the United States; and
- “euro” and “€” refer to the currency of the member states of the European Union (“EU”) that have adopted the single currency in accordance with the treaty establishing the European Community, as amended.

INCORPORATION OF INFORMATION BY REFERENCE

We file annual, semi-annual and special reports and other information with the Securities and Exchange Commission. You may read and copy any document that we file with the SEC at the SEC’s Public Reference Room, 100 F Street, N.E., Washington, D.C. 20549. You can call the SEC on 1-800-SEC-0330 for further information on the Public Reference Room. The SEC’s website, at http://www.sec.gov, contains, free of charge, reports and other information in electronic form that we have filed. You may also request a copy of any filings referred to below (excluding exhibits) at no cost, by contacting us at 25 Gresham Street, London EC2V 7HN, United Kingdom, telephone +44 207 626 1500.

The SEC allows us to incorporate by reference much of the information that we file with them. This means:

- incorporated documents are considered part of this prospectus supplement;
- we can disclose important information to you by referring you to these documents; and

· information that we file with the SEC will automatically update and supersede this prospectus supplement.

We incorporate by reference (i) LBG's Annual Report on Form 20-F for the year ended December 31, 2017 filed with the SEC on March 9, 2018; (ii) LBG's report on Form 6-K filed with the SEC on August 3, 2018 including the interim results for LBG for the six months ended June 30, 2018; (iii) LBG's report on Form 6-K filed with the SEC on August 3, 2018 disclosing the ratio of earnings to fixed charges and the ratio of earnings to combined fixed charges and preference dividends as at June 30, 2018; and (iv) LBG's report on Form 6-K filed with the SEC on August 3, 2018 disclosing LBG's capitalization as at June 30, 2018.

We also incorporate by reference in this prospectus supplement and the accompanying prospectus any future documents we may file with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), from the date of this prospectus supplement until the offering contemplated in this prospectus supplement is completed. Reports on Form 6-K that we may furnish to the SEC after the date of this prospectus supplement (or portions thereof) are incorporated by reference in this prospectus supplement only to the extent that the report expressly states that it is (or such portions are) incorporated by reference in this prospectus supplement.

FORWARD-LOOKING STATEMENTS

From time to time, we may make statements, both written and oral, regarding assumptions, projections, expectations, intentions or beliefs about future events. These statements constitute "forward-looking statements" for

purposes of the Private Securities Litigation Reform Act of 1995. We caution that these statements may and often do vary materially from actual results. Accordingly, we cannot assure you that actual results will not differ materially from those expressed or implied by the forward-looking statements. You should read the sections entitled "Risk Factors" in this prospectus supplement and "Forward-Looking Statements" in our Annual Report on Form 20-F for the year ended December 31, 2017, which is incorporated by reference herein.

We do not undertake any obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, forward-looking events discussed in this prospectus supplement or any information incorporated by reference, might not occur.

IMPORTANT INFORMATION

An investment in the Additional Tier 1 Securities may give rise to higher yields than a bank deposit placed with a deposit taking bank within the Group. However, an investment in the Additional Tier 1 Securities carries risks which are very different from the risk profile of such a bank deposit. See "*Risk Factors*" and "*Interest Cancellation and Automatic Conversion*" below. The Additional Tier 1 Securities may provide greater liquidity than a bank deposit since bank deposits are generally not transferable. Conversely, unlike certain bank deposits, (i) holders of the Additional Tier 1 Securities have no ability to require repayment of their investment and (ii) the Additional Tier 1 Securities are not deposit liabilities of LBG and are not covered by the United Kingdom Financial Services Compensation Scheme or insured by the US Federal Deposit Insurance Corporation or any other governmental agency of the United Kingdom, the United States or any other jurisdiction.

Interest Cancellation and Automatic Conversion – The interest rate following any Reset Date may be less than the initial interest rate and/or the interest rate that applies immediately prior to such Reset Date. Moreover, interest will be due and payable on an Interest Payment Date only to the extent it is not canceled or deemed to have been canceled in accordance with the terms of the Additional Tier 1 Securities. We will have sole and absolute discretion at all times and for any reason to cancel (in whole or in part) any interest payment that would otherwise be payable on any Interest Payment Date. The terms of the Additional Tier 1 Securities also provide for circumstances under which we will be restricted from making an interest payment (in whole or in part) on an Interest Payment Date, and the interest payable in respect of any such Interest Payment Date will be deemed to have been canceled (in whole or in part).

The Additional Tier 1 Securities are perpetual and have no fixed maturity or fixed redemption date. As a result, you may not receive any payments with respect to the Additional Tier 1 Securities as we are not required to pay the principal amount of the Additional Tier 1 Securities at any time prior to a Winding-up or Administration Event (as defined below) and we will have the sole and absolute discretion at all times and for any reason to cancel in whole or in part any interest payment.

By its acquisition of the Additional Tier 1 Securities, each holder and beneficial owner acknowledges and agrees that (a) interest is payable solely at our discretion, and no amount of interest shall become due and payable in respect of the relevant interest period to the extent that it has been canceled by us at our sole discretion and/or deemed canceled in whole or in part; and (b) a cancellation or deemed cancellation of interest (in each case, in whole or in part) in accordance with the terms of the Indenture (as defined herein) shall not constitute a default in payment or otherwise under the terms of the Additional Tier 1 Securities. Interest will only be due and payable on an Interest Payment Date to the extent it is not canceled or deemed canceled in accordance with the provisions described herein. Any interest canceled or deemed canceled (in each case, in whole or in part) in the circumstances described herein shall not be due and shall not accumulate or be payable at any time thereafter, and holders and beneficial owners of the Additional Tier 1 Securities shall have no rights thereto or to receive any additional interest or compensation as a result of such cancellation or deemed cancellation.

If a Trigger Event occurs, then an Automatic Conversion will occur on the Conversion Date, at which point all of our obligations under the Additional Tier 1 Securities shall be irrevocably and automatically released in consideration of our issuance and delivery of the Settlement Shares to the Settlement Share Depository (or other relevant recipient as described herein), and under no circumstances shall such released obligations be reinstated. The Settlement Shares shall initially be registered in the name of the Settlement Share Depository (which shall hold the

Settlement Shares on behalf of the holders of the Additional Tier 1 Securities) or the relevant recipient in accordance with the terms of the Additional Tier 1 Securities. As more fully described herein, we may elect, in our sole and absolute discretion that a Settlement Shares Offer be made by the Settlement Share Depository to all or some of our existing shareholders. The realizable value of any Settlement Shares received by a holder of the Additional Tier 1 Securities following an Automatic Conversion may be significantly less than the pounds sterling equivalent of the Conversion Price (as defined herein) of $0.864 initially and holders of the Additional Tier 1 Securities could lose all or part of their investment in the Additional Tier 1 Securities as a result of the Automatic Conversion.

By its acquisition of the Additional Tier 1 Securities, each holder and beneficial owner shall be deemed to have (i) agreed to all the terms and conditions of the Additional Tier 1 Securities, including, without limitation, those related to (x) Automatic Conversion following the Trigger Event and (y) the appointment of the Settlement Share Depository, the issuance of the Settlement Shares to the Settlement Share Depository (or to the relevant recipient in accordance with the terms of the Additional Tier 1 Securities) and the potential sale of the Settlement Shares pursuant to a Settlement Shares Offer, and acknowledged that such events in (x) and (y) may occur without any further action on the part of the holders or beneficial owners of the Additional Tier 1 Securities or the Trustee, (ii) agreed that effective upon, and following, the Automatic Conversion, no amount shall be due and payable to the holders or beneficial owners of the Additional Tier 1 Securities, and our liability to pay any such amounts (including the principal amount of, or any interest in respect of, the Additional Tier 1 Securities) shall be automatically released, and the holders and beneficial owners shall not have the right to give a direction to the Trustee with respect to the Trigger Event and any related Automatic Conversion, (iii) waived, to the extent permitted by the Trust Indenture Act, any claim against the Trustee arising out of its acceptance of its trusteeship under, and the performance of its duties, powers and rights in respect of, the Indenture and in connection with the Additional Tier 1 Securities, including, without limitation, claims related to or arising out of or in connection with the Trigger Event and/or any Automatic Conversion and (iv) authorised, directed and requested DTC (as defined below) and any direct participant in DTC or other intermediary through which it holds such Additional Tier 1 Securities to take any and all necessary action, if required, to implement the Automatic Conversion without any further action or direction on the part of such holder or beneficial owner or the Trustee.

Prohibition on marketing and sales to retail investors – The Additional Tier 1 Securities are complex financial instruments and are not a suitable or appropriate investment for all investors. In some jurisdictions, regulatory authorities have adopted or published laws, regulations or guidance with respect to the offer or sale of securities such as the Additional Tier 1 Securities to retail investors.

In particular, in June 2015, the U.K. Financial Conduct Authority (the "**FCA**") published the Product Intervention (Contingent Convertible Instruments and Mutual Society Shares) Instrument 2015 (as amended or replaced from time to time) (the "**PI Instrument**"). In addition, (i) on January 1, 2018, the provisions of Regulation (EU) No. 1286/2014 on key information documents for packaged and retail and insurance-based investment products ("**PRIIPs**") became directly applicable in all EEA member states and (ii) the Markets in Financial Instruments Directive 2014/65/EU (as amended) ("**MiFID II**") was required to be implemented in EEA member states by January 3, 2018. Together the PI Instrument, PRIIPs and MiFID II are referred to as the "**regulations**".

The regulations set out various obligations in relation to (i) the manufacture and distribution of financial instruments and (ii) the offering, sale and distribution of packaged retail and insurance-based investment products and certain contingent write-down or convertible securities such as the Additional Tier 1 Securities.

Potential investors in the Additional Tier 1 Securities should inform themselves of, and comply with, any applicable laws, regulations or regulatory guidance with respect to any resale of the Additional Tier 1 Securities (or any beneficial interests therein) including the regulations.

The Underwriters (as defined herein) (and/or their respective affiliates) are required to comply with some or all of the regulations. By purchasing, or making or accepting an offer to purchase any Additional Tier 1 Securities (or a beneficial interest in such Additional Tier 1 Securities) from LBG and/or the Underwriters, each investor represents, warrants, agrees with and undertakes to LBG and each of the Underwriters that:

(1) it is not a retail client in the EEA (as defined in MiFID II);

(2) whether or not it is subject to the regulations, it will not:

a. sell or offer the Additional Tier 1 Securities (or any beneficial interest therein) to retail clients in the EEA (as defined in MiFID II); or

b. communicate (including the distribution of this prospectus supplement) or approve an invitation or inducement to participate in, acquire or underwrite the Additional Tier 1 Securities (or any beneficial interest therein) where that invitation or inducement is addressed to or disseminated in such a way that it is likely to be received by a retail client in the EEA (in each case within the meaning of MiFID II).

In selling or offering the Additional Tier 1 Securities or making or approving communications relating to the Additional Tier 1 Securities it may not rely on the limited exemptions set out in the PI Instrument; and

(3) it will at all times comply with all applicable laws, regulations and regulatory guidance (whether inside or outside the EEA) relating to the promotion, offering, distribution and/or sale of the Additional Tier 1 Securities (or any beneficial interests therein), including (without limitation) in accordance with MiFID II and any other applicable laws, regulations and regulatory guidance relating to determining the appropriateness and/or suitability of an investment in the Additional Tier 1 Securities (or any beneficial interests therein) by investors in any relevant jurisdiction.

Each such investor further acknowledges that:

(i) the identified target market for the Additional Tier 1 Securities (for the purposes of the product governance obligations in MiFID II) is eligible counterparties and professional clients; and

(ii) no key information document (KID) under PRIIPs has been prepared and therefore offering or selling the Additional Tier 1 Securities or otherwise making them available to any retail investor in the EEA may be unlawful under PRIIPs.

PROHIBITION OF SALES TO EEA RETAIL INVESTORS

The Additional Tier 1 Securities are not intended to be offered, sold or otherwise made available to and should not be offered, sold or otherwise made available to any retail investor in the EEA. For these purposes, a retail investor means a person who is one (or more) of: (i) a retail client as defined in MiFID II; or (ii) a customer within the meaning of Directive 2002/92/EC as amended or superseded, ("**IMD**"), where that customer would not qualify as a professional

client as defined in point (10) of Article 4(1) of MiFID II. Consequently, no key information document required by Regulation (EU) No 1286/2014 as amended, (the "**PRIIPs Regulation**") for offering or selling the Additional Tier 1 Securities or otherwise making them available to retail investors in the EEA has been prepared and therefore offering or selling the Additional Tier 1 Securities or otherwise making them available to any retail investor in the EEA may be unlawful under the PRIIPs Regulation.

MIFID II product governance / Professional investors and ECPs only target market – Solely for the purposes of the manufacturer's product approval process, the target market assessment in respect of the Additional Tier 1 Securities has led to the conclusion that: (i) the target market for the Additional Tier 1 Securities is eligible counterparties and professional clients only, each as defined in MiFID II; and (ii) all channels for distribution of the Additional Tier 1 Securities to eligible counterparties and professional clients are appropriate. Any person subsequently offering, selling or recommending the Additional Tier 1 Securities (a distributor) should take into consideration the manufacturer's target market assessment; however, a distributor subject to MiFID II is responsible for undertaking its own target market assessment in respect of the Additional Tier 1 Securities (by either adopting or refining the manufacturer's target market assessment) and determining appropriate distribution channels.

Singapore Securities and Futures Act Product Classification – Solely for the purposes of its obligations pursuant to Sections 309B(1)(a) and 309B(1)(c) of the Securities and Futures Act (Chapter 289 of Singapore) (the "**SFA**"), we have determined, and hereby notify all relevant persons (as defined in Section 309A of the SFA) that the Additional Tier 1 Securities are "prescribed capital markets products" (as defined in the Securities and Futures (Capital Markets Products) Regulations 2018) and "Excluded Investment Products" (as defined in MAS Notice SFA 04-N12: Notice on the Sale of Investment Products and MAS Notice FAA-N16: Notice on Recommendations on Investment Products).

Benchmark Regulation – Amounts payable under the Additional Tier 1 Securities following any Reset Date will be calculated by reference to the 5 year ICE ISDAFIX, one component of which is U.S. dollar LIBOR, each as provided by ICE Benchmark Administration Limited (the "**Administrator**"). As at the date of prospectus supplement, the Administrator appears on the register of administrators and benchmarks established and maintained by the European Securities and Markets Authority pursuant to article 36 of the Benchmark Regulation (Regulation (EU) 2016/1011).

SUMMARY

The following is a summary of this prospectus supplement and should be read as an introduction to, and in conjunction with, the remainder of this prospectus supplement, the accompanying prospectus and any documents incorporated by reference therein. You should base your investment decision on a consideration of this prospectus supplement, the accompanying prospectus and any documents incorporated by reference therein, as a whole. Words and expressions defined in "Description of the Additional Tier 1 Securities" below shall have the same meanings in this summary.

The Issuer

Lloyds Banking Group plc was incorporated as a public limited company and registered in Scotland under the U.K. Companies Act 1985 on October 21, 1985 (registration number 95000). Lloyds Banking Group plc's registered office is at The Mound, Edinburgh EH1 1YZ, Scotland, U.K. and its principal executive offices in England, U.K. are located at 25 Gresham Street, London EC2V 7HN, United Kingdom, telephone number +44 207 626 1500.

The Additional Tier 1 Securities

Issuer	Lloyds Banking Group plc (LEI:549300PPXHEU2JF0AM85)
Securities	Additional Tier 1 Securities
Issue Date	October , 2018
Issue Price	%
Denomination	The Additional Tier 1 Securities will be issued in fully registered form in denominations of $200,000 and in integral multiples of $1,000 thereafter.

Perpetual Securities	The Additional Tier 1 Securities are perpetual securities and have no fixed maturity or fixed redemption date.
Initial Interest Rate	From and including the Issue Date to but excluding September 27, 2025, (the "**First Call Date**"), interest will accrue on the Additional Tier 1 Securities at an initial rate equal to % per annum. From and including each Reset Date to but excluding the next succeeding Reset Date, the interest will accrue on the Additional Tier 1 Securities at a rate per annum equal to the sum of the then-prevailing Mid-Market Swap Rate on the relevant Reset Determination Date (as defined below) and %, such sum being converted to a quarterly rate in accordance with market convention (rounded to three decimal places, with 0.0005 rounded down). Interest will be payable (subject to cancelation as provided herein) quarterly in arrears (with a short first interest period) on each Interest Payment Date.

Benchmark Discontinuation	If the Mid-Market Swap Rate has been permanently discontinued, the Calculation Agent will, as directed by LBG, use as a substitute for the Mid-Market Swap Rate (as described in more detail in "*Description of the Additional Tier 1 Securities*") and for each future Reset Determination Date, the alternative reference rate selected by the central bank, reserve bank, monetary authority or any similar institution (including any committee or working group thereof) that is consistent with accepted market practice (the "**Alternative Rate**"). As part of such substitution, the Calculation Agent will, as directed by LBG, make such adjustments to the Alternative Rate or the spread thereon, as well as the Business Day convention, Reset Determination Dates and related provisions and definitions ("**Adjustments**"), in each case that are consistent with accepted market practice for the use of such Alternative Rate for debt obligations such as the Additional Tier 1 Securities; provided, however, that if there is no clear market consensus as to whether any rate has replaced the Mid-Market Swap Rate in customary market usage, LBG will appoint in its sole discretion an Independent Financial Advisor (in such capacity, the "**IFA**") to determine an appropriate Alternative Rate and any Adjustments, and the decision of the IFA will be binding on LBG, the Calculation Agent, the Trustee, the Paying Agent and the holders of the Additional Tier 1 Securities. If LBG is unable to appoint an IFA, or the IFA appointed by LBG determines that there is no such Alternative Rate as provided above, or otherwise fails to specify an Alternative Rate or any relevant Adjustments, then the Reset Rate of Interest for the relevant Reset Period will be equal to the Reset Rate of Interest in effect with respect to the immediately preceding Reset Period or, in the case of the first Reset Period, the rate of interest will be equal to the rate of interest applicable between the Issue Date and the First Call Date. See also "*Risk Factors— Increased regulatory oversight, changes in the method pursuant to which the LIBOR rates are determined and potential phasing out of LIBOR after 2021 may adversely affect the value of the Additional Tier 1 Securities.*" and "*Description of the Additional Tier 1 Securities—Payments—Benchmark Discontinuation*" below.
Reset Date	The First Call Date and every 5th anniversary thereafter.
Interest Payment Dates	March 27, June 27, September 27 and December 27 of each year, commencing on December 27, 2018.
Interest Payments Discretionary	Interest on the Additional Tier 1 Securities will be due and payable only at the sole discretion of LBG and LBG shall have absolute discretion at all times and for any reason to cancel any interest payment in whole or in part that would otherwise be payable on any Interest Payment Date. If LBG elects not to make an interest payment on the relevant Interest Payment Date, or if LBG elects to make a payment of a portion, but not all, of such interest payment, such non-payment shall evidence LBG's exercise of discretion to cancel such interest payment, or the portion of such interest payment not paid, and accordingly such interest payment, or portion thereof, shall not be or become due and payable. See also "*—Agreement to Interest Cancellation*" and "*Description of the Additional Tier 1 Securities—Payments—Notice of Interest Cancellation*" below.

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Restrictions on Interest Payments	LBG shall cancel any interest on the Additional Tier 1 Securities (or, as appropriate, any part thereof) which is scheduled to be paid on an Interest Payment Date to the extent that LBG has an amount of Distributable Items on any scheduled Interest Payment Date that is less than the sum of (i) all payments (other than redemption payments) made or declared by LBG since the end of LBG's last financial year and prior to such Interest Payment Date on or in respect of any Parity Securities, the Additional Tier 1 Securities and any Junior Securities (as defined below) and (ii) all payments (other than redemption payments) payable by LBG on such Interest Payment Date (x) on the Additional Tier 1 Securities and (y) on or in respect of any Parity Securities or any Junior Securities, in the case of each of (i) and (ii), excluding any payments already accounted for in determining the Distributable Items.

In addition, LBG shall not be permitted to pay any interest otherwise scheduled to be paid on an Interest Payment Date if and to the extent that the payment of such interest would cause, when aggregated together with other distributions of the kind referred to in Article 141(2) of the Directive (as defined below) (or any provision of applicable law transposing or implementing Article 141(2) of the Directive, as amended or replaced) and which are required under the Applicable Regulations to be taken into account for this purpose, the Maximum Distributable Amount (as defined below), if any, then applicable to the Group to be exceeded.

"**Distributable Items**" shall have the meaning assigned to such term in the CRD (as defined below) (as the same may be amended or replaced from time to time), as interpreted and applied in accordance with the Applicable Regulations then applicable to LBG, but amended so that any reference therein to "before distributions to holders of own funds instruments" shall be read as a reference to "before distributions by LBG to holders of Parity Securities, the Additional Tier 1 Securities or any Junior Securities". Under CRD IV, as at the date hereof, "distributable items" means the amount of the profits at the end of the last financial year plus any profits brought forward and reserves available for that purpose before distributions to holders of own funds instruments, less any losses brought forward, profits which are non-distributable pursuant to provisions in legislation or the institution's by-laws and sums placed to non-distributable reserves in accordance with applicable national law or the statutes of the institution, those losses and reserves being determined on the basis of the individual accounts of the institution (LBG) and not on the basis of the consolidated accounts.

"**Junior Securities**" means (i) any Ordinary Share (as defined below) or other securities of LBG ranking, or expressed to rank, junior to the Additional Tier 1 Securities in a Winding-up or Administration Event occurring prior to a Trigger Event and/or (ii) any securities issued by any other member of the Group where the terms of such securities benefit from a guarantee or support agreement entered into by LBG which ranks, or is expressed to rank, junior to the Additional Tier 1 Securities in a Winding-up or Administration Event occurring prior to a Trigger Event.

"**Parity Securities**" means (i) the most senior ranking class or classes of preference shares in the capital of LBG from time to time and any other securities of LBG ranking, or expressed to rank, *pari passu* with the Additional Tier 1 Securities and/or such preference shares following a Winding-up or

Administration Event occurring prior to a Trigger Event and/or (ii) any securities issued by any other member of the Group where the terms of the securities benefit from a guarantee or support agreement entered

into by LBG which ranks, or is expressed to rank, *pari passu* with the Additional Tier 1 Securities and/or such preference shares following a Winding-up or Administration Event occurring prior to a Trigger Event.

Other than in a Winding-up or Administration Event or in relation to the cash component of any Alternative Consideration (as defined below) in any Settlement Shares Offer, payments in respect of or arising under the Additional Tier 1 Securities (including any damages for breach of any obligations thereunder) are, in addition to the right of LBG to cancel payments of interest as described under "*Description of the Additional Tier 1 Securities—Interest Cancellation*", conditional upon LBG being solvent at the time when the relevant payment is due to be made and no principal, interest or other amount payable shall be due and payable in respect of or arising from the Additional Tier 1 Securities except to the extent that LBG could make such payment and still be solvent immediately thereafter (such condition is referred to herein as the "**Solvency Condition**").

LBG shall be considered to be solvent at a particular point in time if:

Solvency Condition

(i) it is able to pay its debts owed to its Senior Creditors (as defined below) as they fall due; and

(ii) its Assets are at least equal to its Liabilities.

"**Assets**" means the unconsolidated gross assets of LBG, as shown in the latest published audited balance sheet of LBG, adjusted for subsequent events in such manner as the directors of LBG may determine.

"**Liabilities**" means the unconsolidated gross liabilities of LBG, as shown in the latest published audited balance sheet of LBG, adjusted for contingent liabilities and prospective liabilities and for subsequent events in such manner as the directors of LBG may determine.

Agreement to Interest Cancellation

By acquiring the Additional Tier 1 Securities, holders and beneficial owners of the Additional Tier 1 Securities acknowledge and agree that:

(a) interest is payable solely at the discretion of LBG, and no amount of interest shall become due and payable in respect of the relevant interest period to the extent that it has been canceled by LBG at its sole discretion and/or deemed canceled in whole or in part; and

(b) a cancellation or deemed cancellation of interest (in each case, in whole or in part) in accordance with the terms of the Indenture shall not constitute a default in payment or otherwise

under the terms of the Additional Tier 1 Securities.

Interest will only be due and payable on an Interest Payment Date to the extent it is not canceled or deemed canceled in accordance with the provisions described under "*Description of the Additional Tier 1 Securities —Interest Cancellation*", "*Description of the Additional Tier 1 Securities —Solvency Condition*", "*Description of the Additional Tier 1 Securities —Availability of Distributable Items*", "*Description of the Additional Tier 1 Securities —Conversion—Automatic Conversion*" and "*Description of the Additional Tier 1 Securities —Ranking and Liquidation Distribution*". Any interest canceled or deemed canceled (in each case, in whole or in part) in the circumstances described above shall not be due and shall not accumulate or be payable at any time thereafter, and holders and beneficial

owners of the Additional Tier 1 Securities shall have no rights thereto or to receive any additional interest or compensation as a result of such cancellation or deemed cancellation.

Ranking and Liquidation Proceeds

The Additional Tier 1 Securities will constitute LBG's direct, unsecured and subordinated obligations, ranking equally without any preference among themselves. The rights and claims of the holders and beneficial owners of the Additional Tier 1 Securities in respect of or arising from the Additional Tier 1 Securities will be subordinated to the claims of Senior Creditors.

Winding-up prior to a Trigger Event

If at any time prior to the date on which a Trigger Event occurs:

(i) an order is made, or an effective resolution is passed, for the winding-up of LBG (except in each such case, a solvent winding-up solely for the purposes of a reorganization, reconstruction or amalgamation of LBG or the substitution in place of LBG of a successor in business of LBG, the terms of which (A) have previously been approved in writing by holders of not less than 2/3 (two thirds) in aggregate principal amount of the Additional Tier 1 Securities and (B) do not provide that the Additional Tier 1 Securities shall thereby become redeemable or repayable in accordance with their terms); or

(i) an administrator of LBG is appointed and such administrator declares, or gives notice that it intends to declare and distribute a dividend (together, a "**Winding-up or Administration Event**"),

there shall be payable by LBG in respect of each Additional Tier 1 Security (in lieu of any other payment by LBG) such amount, if any, as would have been payable to the holder of the Additional Tier 1 Security if, throughout such Winding-up or Administration Event, such holder of the Additional Tier 1 Security was the holder of one of a class of preference shares in the capital of LBG ("**Notional Preference Shares**") having an equal right to a return of assets in the Winding-up or Administration Event to, and so ranking *pari passu* with, the holders of the most senior class or classes of issued preference shares in the capital of LBG from time to time (if any) and which have a preferential right to a return of assets in the Winding-up or Administration Event over, and so rank ahead of, the holders of all other classes of issued shares for the time being in the capital of LBG but ranking junior to the claims of Senior Creditors and on the assumption that the amount that such holder was entitled to receive in respect of each Notional Preference Share is an amount equal to the principal amount of the relevant Additional Tier 1 Security together with, to the extent not otherwise included within the foregoing, any other amounts attributable to such Additional Tier 1 Security, including any Accrued Interest thereon and any damages awarded for breach of any obligations in respect thereof, regardless of whether the Solvency Condition is satisfied on the date upon which the same would otherwise be due and payable (and, in the case of an administration, on the assumption that such shareholders were entitled to claim and recover in respect of their shares to the same degree as in a winding up or

liquidation).

"**Senior Creditors**" means creditors of LBG (i) who are unsubordinated creditors, (ii) whose claims are, or are expressed to be, subordinated to the claims of unsubordinated creditors of LBG but not further or otherwise, or (iii) whose claims are, or are expressed to be, junior to the claims of other creditors of LBG (whether subordinated or unsubordinated, other than those whose claims rank, or are expressed to rank, *pari passu* with, or junior to, the claims of holders of the Additional Tier 1 Securities) in a Winding-up or Administration Event occurring prior to a Trigger Event.

Winding-up following a Trigger Event

If a Winding-up or Administration Event occurs at any time on or following the date on which a Trigger Event occurs but the Settlement Shares to be issued and delivered to the Settlement Share Depository on the Conversion Date have not been so delivered, there shall be payable by LBG in respect of each Additional Tier 1 Security (in lieu of any other payment by LBG) such amount, if any, as would have been payable to the holder of such Additional Tier 1 Security in a Winding-up or Administration Event if the Conversion Date in respect of the Automatic Conversion had occurred immediately before the occurrence of a Winding-up or Administration Event and, accordingly, as if such holder were, through such Winding-up or Administration Event, the holder of such number of Ordinary Shares as it would have been entitled to receive upon Automatic Conversion (ignoring for this purpose LBG's right to make an election for a Settlement Shares Offer to be effected), regardless of whether the Solvency Condition is satisfied on such date (and, in the case of an administration, on the assumption that shareholders were entitled to claim and recover in respect of their shares to the same degree as in a winding up or liquidation).

The "**Conversion Date**" shall be the date specified in the Conversion Trigger Notice (as defined below) and shall occur without delay upon the occurrence of a Trigger Event.

Waiver of Set-Off

Subject to applicable law, no holder or beneficial owner of the Additional Tier 1 Securities may exercise, claim or plead any right of set-off, compensation or retention in respect of any amount owed to it by LBG arising under, or in respect of, or in connection with, the Additional Tier 1 Securities and each holder and each beneficial owner of the Additional Tier 1 Securities shall, by virtue of its holding of any Additional Tier 1 Securities, be deemed to have waived all such rights of set-off, compensation or retention.

Optional Redemption

The Additional Tier 1 Securities will, subject to the satisfaction of the conditions described under "*—Conditions to Redemption, Purchase, Substitution or Variation*" below, be redeemable in whole, but not in part, at the option of LBG on the First Call Date or on any Reset Date thereafter at 100% of their principal amount, together with any accrued and unpaid interest on the Additional Tier 1 Securities, excluding any interest which has been canceled or deemed to be canceled ("**Accrued Interest**") to, but excluding, the date fixed for redemption.

Tax Event Redemption

If at any time a Tax Event has occurred, LBG may, subject to the satisfaction of the conditions described under "*—Conditions to Redemption, Purchase, Substitution or Variation*" below, redeem the Additional Tier 1 Securities in whole but not in part at any time at 100%

of their principal amount, together with any Accrued Interest to, but excluding, the date fixed for redemption.

A "**Tax Event**" will be deemed to have occurred if LBG determines that:

(1) as a result of a Tax Law Change, in making any payments on the Additional Tier 1 Securities, LBG has paid or will or would on the next payment date be required to pay any Additional Amounts to any holder pursuant to "*Description of the Additional Tier 1 Securities—Additional Amounts*"; and/or

(2) a Tax Law Change would:

(i) result in LBG not being entitled to claim a deduction in respect of any payments (or its corresponding funding costs as recognised in LBG's financial statements) in respect of the Additional Tier 1 Securities in computing its taxation liabilities or the amount or value of such deduction to LBG would be materially reduced;

(ii) prevent the Additional Tier 1 Securities from being treated as loan relationships for United Kingdom tax purposes;

(iii) as a result of the Additional Tier 1 Securities being in issue, result in LBG not being able to have losses or deductions set against the profits or gains, or profits or gains offset by the losses or deductions, of companies with which it is or would otherwise be so grouped for applicable United Kingdom tax purposes (whether under the group relief system current as at the date of issue of the Additional Tier 1 Securities or any similar system or systems having like effect as may from time to time exist);

(iv) result in a United Kingdom tax liability, or the receipt of income or profit which would be subject to United Kingdom tax, in respect of a write-down of the principal amount of the Additional Tier 1 Securities or the conversion of the Additional Tier 1 Securities into Ordinary Shares; or

(v) result in an Additional Tier 1 Security or any part thereof being treated as a derivative or an embedded derivative for United Kingdom tax purposes,

in each case, provided that LBG could not avoid the foregoing in connection with the Additional Tier 1 Securities by taking measures reasonably available to it.

"**Tax Law Change**" means a change in, or amendment to, the laws or regulations of the United Kingdom, or any political subdivision or authority therein or thereof, having the power to tax, including any treaty to which the United Kingdom is a party, or any change in any generally published application or interpretation of such laws, including a decision of any court or tribunal, or any change in the generally published application or interpretation of such laws by any relevant tax authority or any generally published pronouncement by any tax authority, which change, amendment or pronouncement (x) (subject to (y)) becomes effective on or after the Issue Date, or (y) in the case of a change in law, if such change is enacted by United Kingdom Act of Parliament or implemented by statutory instrument, on or after the Issue Date.

Regulatory Event Redemption

If at any time a Regulatory Event has occurred, LBG may, subject to the satisfaction of the conditions described under "—*Conditions to Redemption, Purchase, Substitution or Variation*" below, redeem the

Additional Tier 1 Securities in whole but not in part at any time at 100% of their principal amount, together with any Accrued Interest to, but excluding, the date fixed for redemption.

A "**Regulatory Event**" will occur if at any time LBG determines that as a result of a change (which has occurred or which the Relevant Regulator considers to be sufficiently certain) to the regulatory classification of the Additional Tier 1 Securities under the Applicable Regulations, becoming effective on or after the Issue Date, some or all of the outstanding aggregate principal amount of the Additional Tier 1 Securities ceases to be included in, or count towards, the Tier 1 Capital (howsoever defined in the Applicable Regulations) of the Group.

Substitution or Variation

If a Tax Event or a Regulatory Event has occurred, then LBG may, subject to "*Description of the Additional Tier 1 Securities—Conditions to Redemption, Purchase, Substitution or Variation*" below, but without any requirement for the consent or approval of the holders of the Additional Tier 1 Securities, at any time (whether before or following the First Call Date) either substitute all (but not some only) of the Additional Tier 1 Securities for, or vary the terms of the Additional Tier 1 Securities so that they remain or, as appropriate, become, Compliant Securities, and the Trustee shall (subject to the below) agree to such substitution or variation.

Notice of any substitution or variation of the Additional Tier 1 Securities due to the occurrence of a Tax Event or Regulatory Event will be given to holders not less than 30 nor more than 60 calendar days prior to the date of substitution or variation (as applicable) in accordance with "*—Notice*" below, and to the Trustee at least five (5) Business Days prior to the date of such notice to holders, unless a shorter notice period shall be satisfactory to the Trustee. Such notice shall (unless a Trigger Event occurs) be irrevocable and shall specify the date fixed for substitution or, as the case may be, variation of the Additional Tier 1 Securities. Upon the expiry of such notice, LBG shall either vary the terms of or substitute the Additional Tier 1 Securities, as the case may be.

Prior to the giving of any notice of substitution or variation, LBG must deliver to the Trustee an officer's certificate stating that a Regulatory Event or Tax Event, as the case may be, has occurred, setting out the details thereof, and stating that the terms of the relevant Compliant Securities comply with the definition thereof. The Trustee shall be entitled to accept such officer's certificate without any further inquiry, in which event such officer's certificate shall be conclusive and binding on the Trustee and the holders and beneficial owners of the Additional Tier 1 Securities.

"**Compliant Securities**" means securities issued directly by LBG that: (a) have terms not materially less favorable to an investor than the terms of the Additional Tier 1 Securities (as reasonably determined by LBG in consultation with an investment bank or financial adviser of international standing (which in either case is independent of LBG)) and provided that LBG has delivered an officer's certificate to such effect (including as to such consultation) to the Trustee (upon which the Trustee shall be entitled to rely without further enquiry and without liability to any person) prior to the issue or variation of the relevant securities);

(b) subject to (a) above which (1) contain terms which comply with the then current requirements of the Relevant Regulator in relation to additional tier 1 capital; (2) provide for the same interest rate and Interest

Payment Dates from time to time applying to the Additional Tier 1 Securities; (3) rank *pari passu* with the ranking of the Additional Tier 1 Securities; (4) preserve any existing rights under the Indenture to any accrued interest or other amounts which have not been either paid or canceled (but without prejudice to the right of LBG to cancel the same under the terms of the Compliant Securities, if applicable); (5) preserve the obligations (including the obligations arising from the exercise of any right) of LBG as to payments of principal in respect of the Additional Tier 1 Securities, including (without limitation) as to the timing and amount of such payments; and (6) contain terms providing for the conversion of the Additional Tier 1 Securities, the cancellation of payments of interest thereon or write-down of the principal of the Additional Tier 1 Securities only if such terms are not materially less favorable to an investor than the terms of the Additional Tier 1 Securities

(c) are (1) listed on the Global Exchange Market of Euronext Dublin or (2) listed on such other stock exchange as is a Recognized Stock Exchange at that time as selected by LBG; and

(d) where the Additional Tier 1 Securities which have been substituted or varied had a published rating (solicited by, or assigned with the cooperation of, LBG) from a Rating Agency immediately prior to their substitution or variation, each such Rating Agency has ascribed, or announced its intention to ascribe, an equal or higher published rating to the relevant Compliant Securities.

Conditions to Redemption, Purchase, Substitution or Variation

Any redemption, purchase, substitution or variation of the Additional Tier 1 Securities as described above is subject to:

(i) LBG giving notice to the Relevant Regulator and the Relevant Regulator granting permission to LBG to redeem, purchase, substitute or vary the terms of the relevant Additional Tier 1 Securities, as the case may be (in each case to the extent, and in the manner, required by the relevant Applicable Regulations);

(ii) in the case of any redemption or purchase, if and to the extent then required under the then-prevailing Applicable Regulations, either: (A) LBG having replaced the Additional Tier 1 Securities with own funds instruments of equal or higher quality at terms that are sustainable for the income capacity of LBG; or (B) LBG having demonstrated to the satisfaction of the Relevant Regulator that the own funds of LBG would, following such redemption or purchase, exceed its minimum capital requirements (including any capital buffer requirements) by a margin that the Relevant Regulator considers necessary at such time;

(iii) in respect of any redemption proposed to be made prior to the 5th anniversary of the Issue Date, if and to the extent then required under the Applicable Regulations (A) in the case of redemption following the occurrence of a Tax Event, LBG having demonstrated to the satisfaction of the Relevant Regulator that the relevant change or event is material and was not reasonably

foreseeable by LBG as at the Issue Date or (B) in the case of redemption following the occurrence of a Regulatory Event, LBG having demonstrated to the satisfaction of the Relevant Regulator that the relevant change was not reasonably foreseeable by LBG as at the Issue Date;

(iv) in the case of any redemption or purchase, the satisfaction of the Solvency Condition both immediately prior to and immediately following the redemption or purchase date;

(v) a Trigger Event not having occurred; and

(vi) in the case of any substitution or variation, such substitution or variation being effected in compliance with applicable regulatory and legal requirements, including the TIA.

Automatic Conversion

Upon the occurrence of the Trigger Event, each Additional Tier 1 Security shall, on the Conversion Date, be converted in whole and not in part into Ordinary Shares credited as fully paid (the "**Settlement Shares**") at the Conversion Price and in accordance with the terms set forth herein. The Settlement Shares shall be issued and delivered to the Settlement Share Depository on the Conversion Date, in consideration for which all of LBG's obligations under the Additional Tier 1 Securities shall be irrevocably and automatically released (the "**Automatic Conversion**"), and under no circumstances shall LBG's released obligations be reinstated.

Furthermore, in the event of the Automatic Conversion of the Additional Tier 1 Securities upon the occurrence of a Trigger Event, any accrued but unpaid interest on the Additional Tier 1 Securities up to (and including) the Conversion Date shall be canceled upon the occurrence of such Trigger Event and shall not become due and payable at any time.

If LBG has been unable to appoint a Settlement Share Depository, it shall make such other arrangements for the issuance and delivery of the Settlement Shares or of the Alternative Consideration, as applicable, to the holders and beneficial owners of the Additional Tier 1 Securities as it shall consider reasonable in the circumstances, which may include issuing and delivering the Settlement Shares to another independent nominee or to the holders and beneficial owners of the Additional Tier 1 Securities directly, which issuance and delivery shall irrevocably and automatically release all of LBG's obligations under the Additional Tier 1 Securities as if the Settlement Shares had been issued and delivered to the Settlement Share Depository, and, in which case, where the context so admits, references in the Additional Tier 1 Securities and the Indenture to the issue and delivery of Settlement Shares to the Settlement Share Depository shall be construed accordingly and apply *mutatis mutandis*.

The Additional Tier 1 Securities are not convertible at the option of the holders at any time. Automatic Conversion shall not constitute a default under the Additional Tier 1 Securities.

The "**Conversion Date**" shall be the date specified in the Conversion Trigger Notice and shall occur without delay upon the occurrence of a Trigger Event (and shall be no later than one month following the occurrence of the relevant Trigger Event, or such shorter period as the Relevant Regulator may

require).

A “**Trigger Event**” shall occur on any date if the CET1 Ratio is less than 7.00% on such date, as determined by LBG, the Relevant Regulator or any agent appointed for such purpose by the Relevant Regulator.

“**CET1 Ratio**” means, at any date, the ratio of the Group’s CET1 Capital as of such date to Risk Weighted Assets (as defined below) as of the same

such date, expressed as a percentage and on the basis that all measures used in such calculation shall be calculated on a fully loaded basis.

"**CET1 Capital**" means, at any date, the sum, expressed in pounds sterling, of all amounts that constitute Common Equity Tier 1 Capital of the Group as at such date, less any deductions from Common Equity Tier 1 Capital of the Group required to be made as at such date, in each case as calculated by LBG on a consolidated and fully loaded basis in accordance with the Applicable Regulations applicable to the Group as at such date (which calculation shall be binding on the Trustee and holders and beneficial owners of the Additional Tier 1 Securities).

"**Common Equity Tier 1 Capital**" shall have the meaning ascribed to such term in CRD IV (as the same may be amended or replaced from time to time) as interpreted and applied in accordance with the Applicable Regulations then applicable to the Group.

"**fully loaded**" means, in relation to a measure that is presented or described as being on a "fully loaded basis", that such measure is calculated without applying the transitional provisions set out in Part Ten of the Regulation (as may be amended from time to time) in accordance with the Applicable Regulations as at the time such measure is determined.

"**Risk Weighted Assets**" means, at any date, the aggregate amount, expressed in pounds sterling, of the risk weighted assets of the Group as at such date, as calculated by LBG on a consolidated and fully loaded basis in accordance with the Applicable Regulations applicable to the Group on such date (which calculation shall be binding on the Trustee and the holders and beneficial owners of the Additional Tier 1 Securities) and where the term "**risk weighted assets**" means the risk weighted assets or total risk exposure amount, as calculated by LBG in accordance with the Applicable Regulations applicable to the Group as at such date.

Conversion Price

The conversion price per Ordinary Share in respect of the Additional Tier 1 Securities shall be $0.864, subject to the adjustments described under "*Description of the Additional Tier 1 Securities—Anti-dilution Adjustment of the Conversion Price*". As of September 28, 2018, the initial Conversion Price was equivalent to a price of £0.663, translated into U.S. dollars at an exchange rate of £1.00=£1.3031, and rounded down to 3 decimal places.

Settlement Shares Offer

Within ten (10) Business Days following the Conversion Date, LBG may, in its sole and absolute discretion, elect that the Settlement Share Depository (or an agent on its behalf) make an offer of, in LBG's sole and absolute discretion, all or some of the Settlement Shares to, at LBG's sole and absolute discretion, all or some of LBG's ordinary shareholders upon Automatic Conversion, such offer to be at a cash price per Settlement Share that will be no less than the Conversion Price (translated from U.S. dollars into pounds sterling at the then-prevailing rate as determined by LBG in its sole discretion) (the "**Settlement Shares Offer**"). Such election shall be made through the delivery of a "**Settlement Shares Offer Notice**" to the Trustee directly and to the holders of the Additional Tier 1 Securities in accordance with "*Description of the Additional Tier 1 Securities—Notices*" below. If so elected, the Settlement Shares Offer Notice shall specify (i) the period of time for which the Settlement Shares Offer shall be made (the

“**Settlement Shares Offer Period**”), which shall end no later than forty (40) Business Days after the delivery of the Settlement Shares Offer Notice, and (ii) the date on which DTC shall suspend all clearance and settlement of transactions in the Additional Tier

1 Securities in accordance with its rules and procedures (the "**Suspension Date**"), if the Suspension Date has not previously been specified in the Conversion Trigger Notice.

LBG reserves the right, in its sole and absolute discretion, to elect that the Settlement Share Depository terminate the Settlement Shares Offer at any time during the Settlement Shares Offer Period. If LBG makes such an election, it will provide at least three (3) Business Days' notice to the Trustee directly and to the holders of the Additional Tier 1 Securities via DTC. The Settlement Share Depository may then, in its sole and absolute discretion, take steps to deliver to holders of the Additional Tier 1 Securities the Settlement Shares or American Depositary Shares ("**ADSs**") at a time that is earlier than the time at which they would have otherwise received the Alternative Consideration had the Settlement Shares Offer been completed.

Upon expiry of the Settlement Shares Offer Period, the Settlement Share Depository will provide notice to the holders of the Additional Tier 1 Securities in accordance with "*Description of the Additional Tier 1 Securities—Notices*" below of the composition of the Alternative Consideration (and of the deductions to the cash component, if any, of the Alternative Consideration (as set out in the definition of Alternative Consideration)) per $1,000 Tradable Amount of the Additional Tier 1 Securities. The Alternative Consideration will be held by the Settlement Share Depository on behalf of the holders of the Additional Tier 1 Securities and will be delivered to holders of the Additional Tier 1 Securities pursuant to the procedures set forth under "*Description of the Additional Tier 1 Securities—Conversion—Settlement Procedures*" below.

The cash component of any Alternative Consideration shall be payable by the Settlement Share Depository to the holders of the Additional Tier 1 Securities whether or not the Solvency Condition is satisfied.

Agreement with Respect to the Exercise of U.K. Bail-in Powers

Notwithstanding any other agreements, arrangements, or understandings between us and any holder or beneficial owner of the Additional Tier 1 Securities, by purchasing or acquiring the Additional Tier 1 Securities, each holder (including each beneficial owner) of the Additional Tier 1 Securities acknowledges, accepts, agrees to be bound by and consents to the exercise of any U.K. bail-in power (as defined below) by the relevant U.K. resolution authority that may result in (i) the reduction or cancellation of all, or a portion, of the principal amount of, or interest on, the Additional Tier 1 Securities; (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Additional Tier 1 Securities into shares or other securities or other obligations of LBG or another person; and/or (iii) the amendment or alteration of the maturity of the Additional Tier 1 Securities, or amendment of the amount of interest due on the Additional Tier 1 Securities, or the dates on which interest becomes payable, including by suspending payment for a temporary period; any U.K. bail-in power may be exercised by means of variation of the terms of the Additional Tier 1 Securities solely to give effect to the exercise by the relevant U.K. resolution authority of such U.K. bail-in power. With respect to (i), (ii) and (iii) above, references to principal and interest shall include payments of principal and interest that have become due and payable (including principal that has become due and payable at the maturity date), but which have not been paid, prior to the exercise of any U.K. bail-in power. Each holder and each beneficial owner of the Additional Tier 1 Securities further acknowledges and agrees that the rights of the holders and/or beneficial owners under the Additional Tier 1

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Securities are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority.

For these purposes, a "U.K. bail-in power" is any write-down and/or conversion power existing from time to time under any laws, regulations, rules or requirements relating to the resolution of banks, banking group companies, credit institutions and/or investment firms incorporated in the United Kingdom in effect and applicable in the United Kingdom to us and the Group, including but not limited to any such laws, regulations, rules or requirements which are implemented, adopted or enacted within the context of a European Union directive or regulation of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and/or within the context of a U.K. resolution regime under the Banking Act as the same has been or may be amended from time to time (whether pursuant to the Banking Reform Act 2013, secondary legislation or otherwise), pursuant to which obligations of a bank, banking group company, credit institution or investment firm or any of its affiliates can be reduced, canceled, amended, transferred and/or converted into shares or other securities or obligations of the obligor or any other person (and a reference to the "**relevant U.K. resolution authority**" is to any authority with the ability to exercise a U.K. bail-in power).

According to the principles contained in the Bank Recovery and Resolution Directive (the "BRRD") and the amendments to the Banking Act by way of the Banking Reform Act 2013, we expect that the relevant U.K. resolution authority would exercise its U.K. bail-in powers in respect of the Additional Tier 1 Securities having regard to the hierarchy of creditor claims and that the holder or beneficial owner of the Additional Tier 1 Securities would be treated *pari passu* with all claims under Parity Securities at that time being subjected to the exercise by the relevant U.K. resolution authority of the U.K. bail-in powers (or, with claims in respect of ordinary shares, in the event the exercise of such U.K. bail-in power occurs in the intervening period between a Trigger Event and the Conversion Date).

Repayment of Principal and Payment of Interest After Exercise of a U.K. Bail-in Power

No repayment of the principal amount of the Additional Tier 1 Securities or payment of interest on the Additional Tier 1 Securities shall become due and payable after the exercise of any U.K. bail-in power by the relevant U.K. resolution authority unless, at the time that such repayment or payment, respectively, is scheduled to become due, such repayment or payment would be permitted to be made by us under the laws and regulations of the United Kingdom and the European Union applicable to us or other members of the Group.

Enforcement Events and Remedies

The occurrence of a Winding-up or Administration Event prior to the occurrence of a Trigger Event

If a Winding-up or Administration Event occurs prior to the occurrence of a Trigger Event, holders of the Additional Tier 1 Securities will have the rights and claims specified above under "*Ranking and Liquidation Proceeds*".

Non-payment of principal when due

Subject to the satisfaction of any redemption conditions described herein, if LBG does not make payment of principal in respect of the Additional

Tier 1 Securities for a period of seven (7) calendar days or more after the date on which such payment is due, then the Trustee, on behalf of the holders and beneficial owners of the Additional Tier 1 Securities, may, at its discretion, or shall at the direction of holders of 25% of the aggregate principal amount of outstanding Additional Tier 1 Securities, subject to any applicable laws, institute proceedings for the winding up of LBG. In the event of a winding-up or liquidation of LBG, whether or not instituted by the Trustee, the Trustee may prove the claims of the holders and beneficial owners of the Additional Tier 1 Securities and the Trustee in the winding up proceeding of LBG and/or claim in the liquidation of LBG such claims as are set out under "*Description of the Additional Tier 1 Securities—Ranking and Liquidation Distribution*". For the avoidance of doubt, the Trustee may not declare the principal amount of any outstanding Additional Tier 1 Securities to be due and payable and may not pursue any other legal remedy, including a judicial proceeding for the collection of the sums due and unpaid on the Additional Tier 1 Securities.

Breach of a Performance Obligation

In the event of a breach of any term, obligation or condition binding on LBG under the Additional Tier 1 Securities or the Indenture (other than any payment obligation of LBG under or arising from the Additional Tier 1 Securities or the Indenture, including payment of any principal or interest, including any damages awarded for breach of any obligations) (a "**Performance Obligation**"), the Trustee may without further notice institute such proceedings against LBG as it may think fit to enforce the Performance Obligation, provided that LBG shall not by virtue of the institution of any such proceedings be obliged to pay any sum or sums, in cash or otherwise (including any damages) earlier than the same would otherwise have been payable under the Additional Tier 1 Securities or the Indenture.

No other remedies

For the avoidance of doubt, the breach by LBG of any Performance Obligation shall not give the Trustee and/or the holders and beneficial owners of the Additional Tier 1 Securities a claim for damages and, in such circumstances, the sole and exclusive remedy that the Trustee and the holders and beneficial owners of the Additional Tier 1 Securities may seek under the Additional Tier 1 Securities and the Indenture is specific performance under New York law. By its acquisition of the Additional Tier 1 Securities, each Additional Tier 1 holder and each beneficial owner of the Additional Tier 1 Securities acknowledges and agrees that such holder will not seek, and will not direct the Trustee to seek, a claim for damages against LBG in respect of a breach by LBG of a Performance Obligation and that the sole and exclusive remedy that such holder and the Trustee may seek under the Additional Tier 1 Securities and the Indenture for a breach by us of a Performance Obligation is specific performance under New York law. See "*Risk Factors—The Additional Tier 1 Securities do not contain events of default and the remedies available to holders and beneficial owners of the Additional Tier 1 Securities are limited*".

Other than the limited remedies specified above, no remedy against LBG shall be available to the Trustee or the holders or beneficial owners of the Additional Tier 1 Securities, provided that (1) Trustee and the holders and beneficial owners of the Additional Tier 1 Securities shall have such rights and powers as they are required to have

under the TIA, including the right of any holder of the Additional Tier 1 Securities to institute proceedings

for the enforcement of any payments of principal and interest when due, subject to the subordination provisions set forth in the Indenture and (2) such limitations shall not apply to LBG's obligations to pay the fees and expenses of, and to indemnify, the Trustee and the Trustee's rights to apply money collected to first pay its fees and expenses shall not be subject to the subordination provisions set forth in the Indenture.

Holders may not require any redemption of the Additional Tier 1 Securities at any time.

Book-Entry Issuance, Settlement and Clearance	The Additional Tier 1 Securities shall initially be represented by one or more global securities in registered form, without coupons attached, will be deposited with the DTC and will be registered in the name of such depositary or its nominee. Unless and until the Additional Tier 1 Securities are exchanged in whole or in part for other securities under the terms of the Indenture or the global securities are exchanged for definitive securities, the global securities may not be transferred except as a whole by DTC to a nominee or a successor of DTC.
Trustee, Paying Agent and Calculation Agent	The Bank of New York Mellon, a banking corporation duly organized and existing under the laws of the state of New York, acting through its London branch, having its corporate trust office at One Canada Square, London E14 5AL, United Kingdom, will act as the Trustee and will act as initial Paying Agent, and The Bank of New York Mellon, acting through its London branch, will act as Calculation Agent for the Additional Tier 1 Securities.
CUSIP	
ISIN	
Common Code	
CFI	
FISN	
Listing	Application will be made to Euronext Dublin to admit the Additional Tier 1 Securities to the Official List and to trading on the Global Exchange Market, the exchange regulated market of Euronext Dublin, prior to the first Interest Payment Date.
Use of Proceeds	We intend to use the net proceeds of the offering for general corporate purposes. See "*Use of Proceeds*".
Joint-Bookrunning Managers	BNP Paribas Securities Corp., Citigroup Global Markets Inc., Goldman Sachs & Co. LLC, HSBC Securities (USA) Inc. and Lloyds Securities Inc.
Governing Law	The Additional Tier 1 Securities and the Indenture will be governed by and construed in accordance with the laws of the State of New York, except for the subordination and waiver of set-off provisions relating to the Additional Tier 1 Securities which will be governed by and construed in accordance with Scots law.

RISK FACTORS

Prospective investors should consider carefully the risk factors incorporated by reference into this prospectus supplement and as set out below as well as the other information set out elsewhere in this prospectus supplement (including any other documents incorporated by reference herein) and reach their own views prior to making any investment decision with respect to the Additional Tier 1 Securities.

Set out below and incorporated by reference herein are certain risk factors which could have a material adverse effect on our business, operations, financial condition or prospects and cause our future results to be materially different from expected results. Our results could also be affected by competition and other factors. These factors should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties we face. We have described only those risks relating to our operations or an investment in the Additional Tier 1 Securities that we consider to be material. There may be additional risks that we currently consider not to be material or of which we are not currently aware, and any of these risks could have the effects set forth below. All of these factors are contingencies which may or may not occur and we are not in a position to express a view on the likelihood of any such contingency occurring. Investors should note that they bear our solvency risk. Each of the highlighted risks could adversely affect the trading price of the Additional Tier 1 Securities or the rights of investors under the Additional Tier 1 Securities and, as a result, investors could lose some or all of their investment. You should consult your own financial, tax and legal advisers regarding the risks of investment in the Additional Tier 1 Securities. As part of making an investment decision, investors should make sure to thoroughly understand the terms of the Additional Tier 1 Securities, such as the provisions governing the Automatic Conversion (including, in particular, the circumstances under which a Trigger Event may occur), the agreement by you to be bound by the exercise of any U.K. bail-in power by the relevant U.K. resolution authority, that interest is due and payable only at our sole discretion, and that there is no scheduled repayment date for the principal of the Additional Tier 1 Securities.

We believe that the factors described below as relating to the Additional Tier 1 Securities represent the principal risks inherent in investing in the Additional Tier 1 Securities, but we may be unable to pay interest, principal or other amounts on or in connection with the Additional Tier 1 Securities for other reasons and we do not represent that the statements below regarding the risks of holding the Additional Tier 1 Securities are exhaustive. Prospective investors should also read the detailed information set out elsewhere in this prospectus supplement (including any documents deemed to be incorporated by reference herein) and reach their own views prior to making any investment decision.

Risks relating to LBG and the Group

For a description of the risks associated with LBG and the Group, see the section entitled "*Risk Factors*" of our Annual Report on Form 20-F for the year ended December 31, 2017, which is incorporated by reference herein.

Risks relating to the Additional Tier 1 Securities

The Additional Tier 1 Securities have no fixed maturity and no fixed redemption date and you do not have the right to accelerate the repayment of the principal amount of the Additional Tier 1 Securities prior to a Winding-up or Administration Event.

The Additional Tier 1 Securities are perpetual securities and have no fixed maturity date or fixed redemption date. Moreover, you do not have the right to cause the Additional Tier 1 Securities to be redeemed or otherwise accelerate the repayment of the principal amount of the Additional Tier 1 Securities prior to a Winding-up or Administration Event (as described under "*Description of the Additional Tier 1 Securities—Enforcement Events and Remedies*"). Accordingly, we are under no obligation to repay or redeem (in whole or in part) the principal amount of the Additional Tier 1 Securities at any time prior to such Winding-up or Administration Event and, in such event, the claim in respect of the Additional Tier 1 Securities will be deeply subordinated, as provided under "*—LBG's obligations under the Additional Tier 1 Securities are subordinated and will be further subordinated upon Automatic Conversion into Settlement Shares"* below. As a result, you may not receive any payments of principal on the Additional Tier 1 Securities.

The Additional Tier 1 Securities will be subject to Automatic Conversion following the occurrence of a Trigger Event, in which case the Additional Tier 1 Securities will be converted into Settlement Shares.

Upon the occurrence of the Automatic Conversion following a Trigger Event (each as defined under "*Description of the Additional Tier 1 Securities—Conversion—Automatic Conversion*"), the Additional Tier 1 Securities will be converted into Settlement Shares on the Conversion Date; once the Settlement Shares have been issued and delivered to the Settlement Share Depository, all of LBG's obligations under the Additional Tier 1 Securities shall be irrevocably and automatically released and under no circumstances shall such released obligations be reinstated. As a result, you could lose all or part of the value of your investment in the Additional Tier 1 Securities, as, following the Automatic Conversion, you will receive only (i) the Settlement Shares or ADSs (if LBG does not elect that a Settlement Shares Offer be made), or (ii) the Alternative Consideration, which shall be composed of Settlement Shares, ADSs and/or cash depending on the results of the Settlement Shares Offer (if LBG elects that a Settlement Shares Offer be made) and the value of any Settlement Shares or ADSs received upon Automatic Conversion may have a market value significantly below the principal amount of the Additional Tier 1 Securities you hold. Although the market value of the Settlement Shares or ADSs you receive could over time increase in value, at the time the Settlement Shares are issued, the Conversion Price may not reflect the market price of LBG's Ordinary Shares, which could be significantly lower than the Conversion Price. Furthermore, upon the occurrence of the Automatic Conversion, you will no longer have a debt claim in relation to principal and any accrued but unpaid interest on the Additional Tier 1 Securities shall be canceled and shall not become due and payable at any time.

Any such Automatic Conversion will be irrevocable and, upon the occurrence of the Automatic Conversion, holders will not be entitled to any form of compensation in the event of LBG's potential recovery or change in LBG's fully loaded CET1 Ratio. In addition, on or after the occurrence of a Trigger Event, if LBG does not deliver Settlement Shares to the Settlement Share Depository, the only claims holders will have against LBG will be for specific performance to have such Settlement Shares issued and delivered to the Settlement Share Depository and to participate in the liquidation proceeds of LBG as if the Settlement Shares had been issued. Once the Settlement Shares have been issued and delivered to the Settlement Share Depository, the only claims holders will have will be against the Settlement Share Depository for delivery of Settlement Shares, ADSs or Alternative Consideration, as applicable.

A Trigger Event shall occur if on any date LBG, the Relevant Regulator or any agent appointed for such purpose by the Relevant Regulator determines that LBG's CET1 Ratio (which will be calculated on a consolidated and fully loaded basis) is less than 7.00%.

"**CET1 Ratio**" means, at any date, the ratio of the Group's CET1 Capital as of such date to Risk Weighted Assets as of the same such date, expressed as a percentage and on the basis that all measures used in such calculation shall be calculated on a fully loaded basis.

For a discussion of the risks associated with the calculation of LBG's CET1 Ratio see "*—For the purposes of the Trigger Event, the CET1 Ratio will be calculated on a "fully loaded" basis. This will result in a lower calculated CET1 Ratio*

than one using CRD IV transitional provisions, increasing the potential for Automatic Conversion in the short term. Changes to the calculation of CET1 capital and/or risk weighted assets may negatively affect LBG's CET1 Ratio, thereby increasing the risk of a Trigger Event which will lead to the Automatic Conversion, as a result of which your Additional Tier 1 Securities will automatically be converted into Settlement Shares".

See also "*—If a Relevant Event occurs, the Additional Tier 1 Securities may be convertible into shares in an entity other than LBG or may be fully written down." and "—Holders may be obliged to make a take-over bid following a Trigger Event if they take delivery of Settlement Shares*" below.

The circumstances surrounding or triggering the Automatic Conversion are inherently unpredictable and may be caused by factors outside of LBG's control. LBG has no obligation to operate its business in such a way as, or take any mitigating actions, to maintain or restore its CET1 Ratio to avoid a Trigger Event and actions LBG takes could result in its CET1 Ratio falling.

The occurrence of a Trigger Event and, therefore, the Automatic Conversion, is inherently unpredictable and depends on a number of factors, some of which may be outside of LBG's control. Although LBG currently publicly reports the Group's fully loaded CET1 Ratio only as of each quarterly period end, the PRA, or the then relevant

regulatory body with primary responsibility for the prudential supervision of LBG and the Group (the "**Relevant Regulator**"), as part of its supervisory activity, may calculate or instruct LBG to calculate such ratio as of any date, including if LBG is subject to recovery and resolution actions by the relevant U.K. resolution authority (as defined under "Description of the Additional Tier 1 Securities— Redemption, Purchase, Variation and Substitution—Conditions to Redemption, Purchase, Substitution or Variation"), or LBG might otherwise determine to calculate such ratio in its own discretion. As such, the Automatic Conversion could occur at any time. Moreover, it is likely that the relevant U.K. resolution authority would allow a Trigger Event to occur rather than to resort to the use of public funds.

A Trigger Event will occur if LBG, the Relevant Regulator or any agent appointed for such purpose by the Relevant Regulator determines that LBG's CET1 Ratio is below 7.00% as of any such calculation date. Such calculation could be affected by, among other things, the growth of LBG's business and LBG's future earnings, dividend payments, regulatory changes (including changes to definitions and calculations of regulatory capital, including CET1 Capital and Risk Weighted Assets (each of which shall be calculated by LBG on a fully loaded, consolidated basis and such calculation shall be binding on the Trustee and on the person in whose name the Additional Tier 1 Security is registered)), actions that LBG is required to take at the direction of the Relevant Regulator, and the Group's ability to manage Risk Weighted Assets in both its ongoing businesses and those which it may seek to exit. In addition, the Group has capital resources and risk weighted assets denominated in foreign currencies, and changes in foreign exchange rates will result in changes in the pounds sterling equivalent value of foreign currency denominated capital resources and risk weighted assets. Actions that LBG takes could also affect its CET1 Ratio, including causing it to decline. LBG has no obligation to increase its CET1 Capital, reduce its Risk Weighted Assets or otherwise operate its business in such a way as, take mitigating actions to prevent its CET1 Ratio from falling below 7.00%, maintain or increase its CET1 Ratio or otherwise consider the interests of the holders of the Additional Tier 1 Securities in connection with any of its business decisions that might affect LBG's CET1 Ratio.

The calculation of LBG's CET1 Ratio may also be affected by changes in applicable accounting rules, or by changes to regulatory adjustments which modify the regulatory capital impact of accounting rules. For example, we have adopted IFRS 9, which is expected to increase impairment charges to reflect expected credit losses and may cause impairment charges to be more volatile. Impairment charges may cause significant decreases in our CET1 Ratio, especially given that the transitional arrangements published by the EU (which soften the impact that IFRS 9 has on our loan loss allowances) will be phased out by the end of 2022. In addition, we continue to test and refine our models for purposes of determining expected credit losses in preparation for the disclosure required in our financial statements for the year ending December 31, 2018, and any revisions to our models may result in significant changes to our regulatory capital position. Even if changes in applicable accounting rules, or changes to regulatory adjustments that modify the regulatory impact of accounting rules, are not yet in force as of the relevant calculation date, the Relevant Regulator could require us to reflect such changes in any particular calculation of the CET1 Ratio. Moreover, the Group's CET1 Ratio is a non-IFRS measure, and our interpretation of CRD IV and the basis of our calculation of this financial measure may be different from those of other financial institutions. Accordingly, accounting changes or regulatory changes may have a material adverse impact on LBG's calculations of regulatory capital resources and requirements, including CET1 Capital and Risk Weighted Assets, and LBG's CET1 Ratio.

Because of the inherent uncertainty regarding whether a Trigger Event will occur and there being no obligation on LBG's part to prevent its occurrence, it will be difficult to predict when, if at all, Automatic Conversion could occur. Accordingly, the trading behavior of the Additional Tier 1 Securities may not necessarily follow the trading behavior

of other types of subordinated securities, including LBG's other subordinated debt securities. Fluctuations in the CET1 Ratio may be caused by changes in the amount of CET1 Capital and Risk Weighted Assets as well as changes to their respective definitions under the capital adequacy standards and guidelines set by the Relevant Regulator and changes in accounting rules. Any indication that the Group's CET1 Ratio is moving towards the level which would cause the occurrence of a Trigger Event may have an adverse effect on the market price and liquidity of the Additional Tier 1 Securities. Therefore, investors may not be able to sell their Additional Tier 1 Securities easily or at prices that will provide them with a yield comparable to other types of subordinated securities, including LBG's other subordinated debt securities. In addition, the risk of Automatic Conversion could drive down the price of LBG's ordinary shares ("**Ordinary Shares**") and have a material adverse effect on the market value of Settlement Shares received upon Automatic Conversion.

For the purposes of the Trigger Event, the CET1 Ratio will be calculated on a "fully loaded" basis. This will result in a lower calculated CET1 Ratio than one using CRD IV transitional provisions, increasing the potential for Automatic Conversion in the short term. Changes to the calculation of CET1 capital and/or risk weighted assets may negatively affect LBG's CET1 Ratio, thereby increasing the risk of a Trigger Event which will lead to the Automatic Conversion, as a result of which your Additional Tier 1 Securities will automatically be converted into Settlement Shares.

LBG is required to calculate its capital resources for regulatory purposes on the basis of "common equity tier 1 capital" as determined in accordance with the Capital Requirements Directive (the "**CRD**") and the Capital Requirements Regulation (together with CRD, "**CRD IV**"). LBG is also required to calculate its "risk weighted assets", which represent assets adjusted for their associated risks, on the basis set out in CRD IV. Each of these definitions will be calculated in accordance with the capital adequacy standards and guidelines of the Relevant Regulator applicable to LBG on the relevant date.

The CRD IV legislation sets out a minimum pace of introduction of such enhanced capital requirements (the "**Transitional Provisions**"). The Transitional Provisions were designed to implement certain CRD IV requirements in stages over a prescribed period commencing in 2014; however, each of the EU Member States had the discretion to accelerate that minimum pace of transition in certain respects. In the United Kingdom, the PRA required the Group to meet certain capital targets, without having regard to any Transitional Provisions in that respect. New elective Transitional Provisions, which amended CRD IV in late 2017, were introduced to off-set the regulatory capital impact of IFRS 9. LBG has elected to apply those Transitional Provisions since January 1, 2018.

However, for the purposes of the Additional Tier 1 Securities, LBG will calculate its CET1 Capital and Risk Weighted Assets without applying any Transitional Provisions (including those relating to IFRS 9) and will instead calculate its CET1 Ratio on a so-called "fully loaded" basis, which is a more stringent basis than permitted under the CRD IV regime as applicable to LBG and is expected to lead to the CET1 Ratio as defined for purposes of the Additional Tier 1 Securities being lower than it would be were LBG to calculate the common equity tier 1 ratio applying the Transitional Provisions (and, in particular, the IFRS 9 phase-in arrangements) to its calculation of common equity tier 1 capital and risk weighted assets. In addition, the application of IFRS 9 is expected to result in greater changes from period to period in the level of provisions, which in turn would result in greater volatility over time in LBG's income and, consequently, LBG's CET1 Ratio.

At June 30, 2018, LBG's CET1 Ratio giving full effect to CRD IV on a fully loaded basis was 14.1 per cent. and was also 14.1 per cent. once the transitional capital relief provided for by the Transitional Provisions was applied. LBG's CET1 Ratio is a non-IFRS measure, and LBG's interpretation of CRD IV and the basis of LBG's calculation of this financial measure may be different from those of other financial institutions. For further information, see the section entitled "*Risk Management*" of our interim results on Form 6-K for the six months ended June 30, 2018.

If the PRA rules, guidance or expectations in relation to capital or leverage were to be amended in the future in a manner other than as set out in its current statements of policy, and depending on the content of any binding

regulatory technical standards developed by the EBA, it could be materially more difficult for the Group to maintain compliance with prudential requirements. Any such changes, either individually and/or in aggregate, may lead to further unexpected enhanced requirements in relation to the Group's capital and may result in a need for further management actions to meet the changed requirements, such as: increasing capital, reducing leverage and risk weighted assets, modifying legal entity structure (including with regard to issuance and deployment of capital and funding for the Group) and changing the Group's business mix or exiting other businesses and/or undertaking other actions to strengthen the Group's capital position.

Investors should be aware that the CRD IV rules and their implementation in the United Kingdom subsequent to the date hereof, as well as any changes in applicable accounting rules, may individually and/or in the aggregate further negatively affect LBG's CET1 Ratio and thus increase the risk of a Trigger Event, which will lead to the Automatic Conversion. Upon the occurrence of the Automatic Conversion, provided that LBG issues and delivers the Settlement Shares to the Settlement Share Depository in accordance with the terms described herein, investors will have no rights against LBG with respect to the repayment of the principal amount of the Additional Tier 1 Securities or the payment of any accrued and unpaid interest on such Additional Tier 1 Securities. In addition, the realizable value of the Settlement Shares may be below the Conversion Price. Although the market value of any Settlement Shares you receive could over time increase, at the time the Settlement Shares are issued, the Conversion

Price may not reflect the market price of LBG's Ordinary Shares, which could be significantly lower than the Conversion Price.

The Additional Tier 1 Securities have no scheduled maturity and holders of the Additional Tier 1 Securities only have a limited ability to cash in their investment in the Additional Tier 1 Securities.

The Additional Tier 1 Securities are perpetual securities and have no fixed maturity date or fixed redemption date. Although under certain circumstances as described under "*Description of the Additional Tier 1 Securities—Redemption, Purchase, Variation and Substitution*" LBG may redeem the Additional Tier 1 Securities, LBG is under no obligation to do so and holders of the Additional Tier 1 Securities have no right to call for their redemption. Therefore, holders of the Additional Tier 1 Securities have no ability to cash in their investment, except (i) if LBG exercises its rights to redeem the Additional Tier 1 Securities in accordance with their terms and applicable laws, (ii) by selling their Additional Tier 1 Securities or, following the occurrence of a Trigger Event and the issue and delivery of Settlement Shares or ADSs, their Settlement Shares or ADSs (if LBG does not elect that a Settlement Shares Offer be made or where the Settlement Shares issued are not all sold pursuant to the Settlement Shares Offer), (iii) through the cash component of any Settlement Shares Offer, (iv) where the Trustee institutes proceedings for the winding-up of LBG where LBG has exercised its right to redeem the Additional Tier 1 Securities but fails to make payment in respect of such redemption when due, in which limited circumstances the holders of the Additional Tier 1 Securities may receive some of any resulting liquidation proceeds following payment being made in full to all senior and more senior subordinated creditors, or (v) upon a Winding-up or Administration Event in which limited circumstances the holders of the Additional Tier 1 Securities may receive some of any resulting liquidation proceeds following payment being made in full to all senior or more senior subordinated creditors.

Interest payments on the Additional Tier 1 Securities are discretionary and LBG may cancel interest payments, in whole or in part, at any time. Canceled interest shall not be due and shall not accumulate or be payable at any time thereafter and investors shall have no rights thereto.

Subject to the Solvency Condition described under "Description of the Additional Tier 1 Securities—Payments—Solvency Condition" and the availability of Distributable Items as described under "Description of the Additional Tier 1 Securities—Payments—Availability of Distributable Items", interest on the Additional Tier 1 Securities will be due and payable only at the sole discretion of LBG and LBG shall have absolute discretion at all times and for any reason to cancel any interest payment in whole or in part that would otherwise be payable on any Interest Payment Date. Interest will only be due and payable on an Interest Payment Date to the extent it is not canceled in accordance with the terms of the Additional Tier 1 Securities. If LBG cancels any scheduled interest payment, such interest payment shall not be or become due and payable at any time thereafter and in no event will holders of the Additional Tier 1 Securities have any right to or claim against LBG with respect to such interest amount or be able to accelerate the principal of the Additional Tier 1 Securities as a result of such interest cancellation. Furthermore, no cancellation of interest in accordance with the terms of the Indenture shall constitute a default in payment or otherwise under the terms of the Additional Tier 1 Securities. There can, therefore, be no assurances that a holder will receive interest payments in respect of the Additional Tier 1 Securities.

For further information on LBG's dividend policy, see our Annual Report on Form 20-F for the year ended December 31, 2017 under the heading "*Dividends*". The Additional Tier 1 Securities will rank senior to Ordinary Shares. It is the Board of Directors' current intention that, whenever exercising its discretion to declare Ordinary Share dividends, or its discretion to cancel interest on the Additional Tier 1 Securities, the Board will take into account the relative ranking of these instruments in LBG's capital structure. However, the Board may at any time depart from this policy at its sole discretion.

Following cancellation of any interest payment, LBG will not be in any way limited or restricted from making any distribution or equivalent payments in connection with any Parity Securities or Junior Securities, including any dividend payments on LBG's Ordinary Shares or preference shares. LBG may therefore cancel (in whole or in part) any interest payment on the Additional Tier 1 Securities at its discretion and may pay dividends on its ordinary or preference shares or on other additional tier 1 securities notwithstanding such cancellation. In addition, LBG may without restriction use funds that could have been applied to make such canceled payments to meet its other obligations as they become due.

In addition to LBG's right to cancel, in whole or in part, interest payments at any time, the terms of the Additional Tier 1 Securities also restrict LBG from making interest payments on the Additional Tier 1 Securities if LBG has insufficient Distributable Items (based on its individual accounts and not on its consolidated accounts), in which case such interest shall be deemed to have been canceled. LBG will also be required to cancel interest payments if any payment cannot be made in compliance with the Solvency Condition, or if payment would result in any maximum distributable amount then applicable to the Group to be exceeded.

Subject to the extent permitted in the following paragraphs in respect of partial interest payments, LBG shall not make an interest payment on the Additional Tier 1 Securities on any Interest Payment Date (and such interest payment shall therefore be deemed to have been canceled and thus shall not be due and payable on such Interest Payment Date) (a) to the extent that an amount of Distributable Items on any scheduled Interest Payment Date is less than the sum of (i) all payments (other than redemption payments) made or declared by LBG since the end of LBG's last financial year and prior to such Interest Payment Date on or in respect of any Parity Securities, the Additional Tier 1 Securities, and any Junior Securities (as defined below) and (ii) all payments (other than redemption payments) payable by LBG on such Interest Payment Date (x) on the Additional Tier 1 Securities and (y) on or in respect of any Parity Securities or any Junior Securities, in the case of each of (i) and (ii), excluding any payments already accounted for in determining the Distributable Items, or (b) if the Solvency Condition is not satisfied in respect of such interest payment.

In addition, LBG shall not be permitted to pay interest otherwise scheduled to be paid on an Interest Payment Date if and to the extent that the payment of such interest would cause, when aggregated together with other distributions of the kind referred to in Article 141(2) of the CRD IV Directive (or any provision of applicable law transposing or implementing Article 141(2) of such Directive, as amended or replaced) and which are required under the Applicable Regulations to be taken into account for this purpose, the Maximum Distributable Amount (if any) then applicable to the Group to be exceeded. See also "*—CRD IV introduced restrictions on distributions that will restrict LBG from making interest payments on the Additional Tier 1 Securities in certain circumstances, in which case LBG will cancel such interest payments*."

Although LBG may, in its sole discretion, elect to make a partial interest payment on the Additional Tier 1 Securities on any Interest Payment Date, it may only do so to the extent that such partial interest payment may be made without breaching the restrictions in the preceding paragraphs.

Any interest canceled or deemed canceled on any relevant Interest Payment Date shall not be due and shall not accumulate or be payable at any time thereafter, and holders of the Additional Tier 1 Securities shall have no rights thereto or to receive any additional interest or compensation as a result of such deemed cancellation. Furthermore, no cancellation of interest in accordance with the terms of the Indenture shall constitute a default in payment or otherwise under the terms of the Additional Tier 1 Securities.

As a holding company, the level of Distributable Items is affected by a number of factors, and insufficient Distributable Items may restrict LBG's ability to make interest payments on the Additional Tier 1 Securities.

As a holding company, the level of LBG's Distributable Items is affected by a number of factors, principally its ability to receive funds, directly or indirectly, from LBG's operating subsidiaries in a manner which creates Distributable Items. Consequently, LBG's future Distributable Items, and therefore LBG's ability to make interest payments, are a function of LBG's existing Distributable Items, future Group profitability and performance and the ability to distribute or dividend profits from LBG's operating subsidiaries up the Group structure to LBG. In addition, the LBG's Distributable Items will also be reduced by the servicing of other debt and equity instruments.

The ability of the LBG's subsidiaries to pay dividends and LBG's ability to receive distributions and other payments from LBG's investments in other entities is subject to applicable local laws and other restrictions, including their respective regulatory, capital and leverage requirements, statutory reserves, financial and operating performance and applicable tax laws, and any changes thereto. These laws and restrictions could limit the payment of dividends, distributions and other payments to LBG by LBG's subsidiaries, which could in time restrict LBG's ability to fund other operations or to maintain or increase its Distributable Items.

The level of our Distributable Items may be further affected by changes to regulation or the requirements and expectations of applicable regulatory authorities. In particular, local capital or ring-fencing requirements both inside

and outside the U.K. could adversely affect our Distributable Items in the future, such as, for example, the U.K. ring-fencing requirements which will apply from January 2019 and the implementation of section 165 of the Dodd-Frank Act, which has now been completed, including regulatory capital and internal TLAC requirements and buffers applicable to intermediate holding companies ("**IHCs**") in the United States and potential restrictions on such IHCs' ability to engage in capital distributions.

Further, our Distributable Items may be adversely affected by the performance of the Group's business in general, factors affecting its financial position (including capital and leverage), the economic environment in which the Group operates and other factors outside of our control. See "*—Risks Relating to LBG and the Group*".

Our Distributable Items are also sensitive to the accounting impact of factors such as the redemption of preference shares, restructuring costs and impairment charges and the carrying value of our investments in subsidiaries, which are carried at the lower of cost and their prevailing recoverable amount. Recoverable amounts depend on discounted future cash flows, which can be affected by restructurings, such as the requirement to implement the U.K. ring-fencing regime or unforeseen events. Any of these factors could limit our ability to maintain sufficient Distributable Items.

CRD IV introduced restrictions on distributions that will restrict LBG from making interest payments on the Additional Tier 1 Securities in certain circumstances, in which case LBG will cancel such interest payments.

The capital and leverage frameworks to which we are subject require us to hold certain levels of capital, including common equity Tier 1 capital. A failure to hold sufficient levels of capital, including common equity Tier 1 capital, as required by these frameworks (as may be amended from time to time) may result in restrictions on distributions being applied pursuant to which we may be required to cancel (in whole or in part) interest payments in respect of the Additional Tier 1 Securities. Cancellation (in whole or in part) of interest payments in respect of the Additional Tier 1 Securities may affect the value of your investment in the Additional Tier 1 Securities.

We are required, on a consolidated basis, to hold a minimum amount of total regulatory capital of 8% of risk weighted assets, a minimum amount of Tier 1 Capital of 6% of risk weighted assets and a minimum amount of common equity Tier 1 capital of 4.5% of risk weighted assets (the "**Pillar 1 requirements**"). In addition, the PRA requires us to hold extra capital to cover risks not covered or insufficiently covered by the Pillar 1 requirements (the "**Pillar 2A requirements**"). Our current Pillar 2A requirement as of June 30, 2018 is 4.6% of risk weighted assets, of which at least 56% must be met with common equity Tier 1 capital and no more than 25% tier 2 capital. In addition, the capital that firms use to meet their minimum requirements (Pillar 1 own funds and Pillar 2A) cannot be counted towards meeting the "combined buffer requirement", meaning that the combined buffer requirement will effectively be applied above both the Pillar 1 own funds and Pillar 2A requirements.

In addition to the requirements described above, CRD IV introduced several capital buffers, which are required to be met with common equity Tier 1 capital and will be fully phased in by 1 January 2019. The combination of (i) the capital conservation buffer (the "**CCB**") (which is being phased in gradually and will rise to 2.5% from 2019), (ii) the time-varying countercyclical capital buffer ("**CCyB**") (which will vary over time depending on the effective rates set by regulators in countries where we have relevant credit exposures), (iii) the higher of (A) the global systemically important institutions buffer or other systemically important institutions buffer and (B) the systemic risk buffer constitutes the "combined buffer".

The CCB is a standard buffer of 2.5% of risk-weighted assets designed to provide for losses in the event of stress and is being phased in over the period from January 1, 2016 to January 1, 2019. During 2017 it was 1.25% and during 2018 it increases to 1.875%. The CCyB is time varying; the amount of the buffer is determined by reference to buffer rates set by the Financial Policy Committee of the Bank of England (FPC) for the individual countries where the Group has relevant credit risk exposures. The CCyB rate for the U.K. is currently set at 0.5% as of June 27, 2018 but will increase to 1.0% on November 28, 2018. The FPC is expected to reconsider the adequacy of a 1.0% U.K. CCyB rate during 2018 in light of the evolution of the overall risk environment. Non-zero buffer rates currently apply for Norway, Sweden, Hong Kong, Iceland, Slovakia and the Czech Republic. Given that the Group has minimal exposures to these jurisdictions, the overall CCyB requirement at June 30, 2018 was considered by LBG to be 0.4%.

Although the Group is not currently classified as a global systemically important institution (G-SII), it has been classified as an ‘other’ systemically important institution (“**O-SII**”) by the PRA. The O-SII buffer is currently set to zero in the U.K.

The systemic risk buffer is expected to be set by the PRA for the first time with effect from 2019.

The PRA introduced a firm-specific Pillar 2B buffer (the “**PRA buffer**”), which is set at a level that the PRA believes will ensure that a bank can continue to meet minimum Pillar 1 and Pillar 2A requirements during a stressed period and may also be used to address any significant weaknesses in a firm’s risk management and governance, and to reflect at Group level the application of the systemic risk buffer to subsidiaries of the Group. The PRA assesses the PRA buffer applicable to an institution annually (or more often if a firm’s circumstances change). Where the PRA considers there is an overlap between the combined buffer and the PRA buffer, the PRA buffer will be set as the excess capital required over and above the combined buffer. To the extent the PRA buffer is applicable, it must be met with 100% common equity Tier 1 capital, which will be in addition to the common equity Tier 1 capital used to meet the Pillar 1 and Pillar 2A capital requirements. Further, failure to meet requirements of regulatory stress tests, or the failure by regulators to approve the stress test results and capital plans of the Group, could result in the Group or certain of its members being required to enhance their capital position, including, for example, an additional PRA buffer or through sectoral capital requirements set by the Financial Policy Committee.

The PRA has also introduced requirements in relation to minimum leverage ratios pursuant to which we are required to meet (i) a minimum leverage ratio requirement set at 3.25% (calculated by dividing a firm’s Tier 1 capital by its total exposure measure (as defined in CRR)) applicable from October 3, 2017 (the “**PRA Leverage Ratio**”), (ii) an additional leverage ratio buffer that is calibrated at 35% of the systemic risk buffer (“**ALRB**”) (applicable from 2019) and (iii) a countercyclical leverage ratio buffer that is calibrated at 35% of the CCyB (“**CCyLB**”). At least 75% of the Tier 1 capital required to meet the PRA Leverage Ratio must consist of common equity Tier 1 capital (with the remainder to be met with additional Tier 1 capital), while the ALRB and CCyLB must be met entirely with common equity Tier 1 capital. As at the date of this prospectus supplement, the leverage ratio framework does not give rise to higher capital requirements for the Group than the risk-based capital framework.

Under Article 141 of CRD (and any implementation of such provision in the U.K. or, as the case may be, any succeeding provision amending or replacing such provision or any such implementing provision), Member States must require institutions that fail to meet the combined buffer to be subject to restricted “discretionary payments” (which are defined broadly by CRD IV as payments or distributions relating to common equity Tier 1, variable remuneration and payments on additional Tier 1 instruments (such as the Additional Tier 1 Securities)). Since these requirements apply to institutions on a consolidated basis, the PRA can indirectly impose these restrictions on us. The restrictions for failing to meet the combined buffer is scaled according to the extent of the breach of the combined buffer and calculated as a percentage of the profits of the institution since the last distribution of profits or discretionary payment. Such calculation will result in a maximum distributable amount in each relevant period. As an example, the scaling is such that in the bottom quartile of the combined buffer, no discretionary payments will be permitted to be paid. As a consequence, in the event of breach of the combined buffer, it may be necessary to reduce or cancel discretionary payments in whole or in part, including potentially cancelling (in whole or in part) scheduled interest payments in

respect of the Additional Tier 1 Securities.

The PRA also has the power under section 192C of the Financial Services and Markets Act 2000 (the "**FSMA**") (implementing Article 104 of CRD as regards bank holding companies) to impose requirements on us or our regulated subsidiaries, the effect of which may be to restrict or prohibit payments of interest to you, which is most likely to materialize if at any time we are failing, or are expected to fail, to meet our capital requirements. If the PRA exercises its discretion, we will cancel (in whole or in part, as required by the PRA) interest payments in respect of the Additional Tier 1 Securities.

In addition, failure to meet the PRA buffer, to pass PRA or EBA stress tests or to satisfy leverage ratios or buffers could result in the preparation of a capital restoration plan. Such capital restoration plan may impose restrictions on discretionary payments, which may result in in a need for management actions including the cancellation (in whole or in part) of interest payments in respect of the Additional Tier 1 Securities.

Changes to the capital and leverage frameworks may increase our capital requirements and may increase the risk that we will be subject to restrictions on distributions (resulting in our being required to cancel (in whole or in part) interest payments in respect of the Additional Tier 1 Securities. For example, the Basel Committee revised the

Basel III capital framework in December 2017 to incorporate a leverage ratio buffer for global systematically important banks ("**G-SIBs**") (the "**Basel III leverage ratio buffer**") that will be set at 50% of the Basel G-SIB buffer (which has been implemented in the EU as the G-SII buffer) and would restrict a G-SIB from making capital distributions (including interest payments on additional Tier 1 capital instruments, such as the Additional Tier 1 Securities) if the G-SIB's Basel III leverage ratio does not meet or exceed its Basel III leverage ratio buffer. In the European Union, the implementation is expected to be via CRR2 (as defined below). In June 2018, the Financial Policy Committee of the Bank of England announced it intended to conduct a comprehensive review of the leverage ratio framework in light of the revised international standards, including Basel III and CRR2. In particular, this review would set out the effect of extending leverage ratio requirements and buffers to PRA-regulated firms. Depending on how and when the leverage ratio buffer is implemented in the U.K., we may be restricted from making interest payments on the Additional Tier 1 Securities if we fail to meet the leverage ratio buffer as so implemented. In addition, our minimum regulatory capital requirements may increase as a result of increased provisioning under stress associated with our adoption of IFRS 9 as of January 1, 2018, the magnitude of which will depend upon several factors, including the specified stress scenario. We expect the Bank of England to clarify the interaction between IFRS 9 and stress-testing frameworks in 2018. See "*—The circumstances surrounding or triggering the Automatic Conversion are inherently unpredictable and may be caused by factors outside of LBG's control. LBG has no obligation to operate its business in such a way, or take any mitigating actions, to maintain or restore its CET1 Ratio to avoid a Trigger Event and actions LBG takes could result in its CET1 Ratio falling*."

Separately, certain aspects of the U.K. regulatory regime may restrict or prohibit us further from making interest payments on the Additional Tier 1 Securities in certain circumstances. For example, the BRRD requires member states to enable their resolution authorities to set a minimum requirement for eligible liabilities ("**MREL**") for banks in their jurisdiction. The U.K. has implemented the MREL requirements through the U.K. Banking Act 2009, as amended (the "**Banking Act**"), and the Bank Recovery and Resolution (No 2) Order 2014 (which is expected to be further amended to reflect the proposals published by the European Commission on, and following, November 23, 2016 for amendments to the BRRD and CRD IV ("**CRR2**") in relation to the MREL requirements), and PRA Supervisory Statement SS 16/16 which supervisory statement should be read in conjunction with the Bank of England's statement of policy on its approach to setting MREL. The current U.K. MREL regime, which will take effect as of January 1, 2019 for material subsidiaries of G-SIIs and as of January 1, 2020 for all other firms and which will be phased in until January 1, 2022, has been designed to be broadly compatible with the term sheet published by the Financial Stability Board (the "**FSB**") on total loss absorbing capacity ("**TLAC**") requirements for G-SIBs (which are referred to as G-SIIs under the EU proposals). Where a bank falls short of the total requirement for eligible liabilities, then, while there would not be an automatic restriction the PRA may use its powers to restrict or prohibit the firm from making distributions where such a measure is appropriate and proportionate in the circumstances. As a result, the implementation of the MREL and TLAC requirements in the U.K. may result in the reduction of discretionary payments (in whole or in part), including the cancellation (in whole or in part) of interest payments in respect of the Additional Tier 1 Securities.

Our capital requirements, including Pillar 2A requirements, by their nature, are calculated by reference to a number of factors, any one or a combination of which may not be easily observable or capable of calculation by you. Moreover, the interaction of restrictions on distributions (including interest payments on the Additional Tier 1 Securities) with, and impact of, the capital requirements and buffers and leverage framework applicable to the Group, as well as the current implementation of MREL and TLAC, remain uncertain in many respects. Such uncertainty is expected to continue while the relevant authorities in the EU and the U.K. consult on and develop their proposals and provide guidance on the application of the rules and in light of Brexit. See "*—Other changes in law may adversely affect your*

rights as a holder." Changes to these rules, including from the implementation of CRR2, could result in more 1 capital and MREL required to be held by a financial institution in order to prevent the maximum distributable amount or other regulatory restrictions from applying. As a result, you may not be able to anticipate whether we will need to reduce discretionary payments, including by cancelling interest payments (in whole or in part) in respect of the Additional Tier 1 Securities, which may affect the value of your investment in the Additional Tier 1 Securities.

The Additional Tier 1 Securities may be traded with accrued interest, but under certain circumstances described above, such interest may be canceled and not paid on the relevant Interest Payment Date.

The Additional Tier 1 Securities may trade, and/or the prices for the Additional Tier 1 Securities may appear, on the Global Exchange Market of Euronext Dublin and in other trading systems with accrued interest. If this occurs, purchasers of Additional Tier 1 Securities in the secondary market will pay a price that reflects such accrued interest

upon purchase of the Additional Tier 1 Securities. However, if a payment of interest on any Interest Payment Date is canceled or deemed canceled (in each case, in whole or in part) as described herein and thus is not due and payable, purchasers of such Additional Tier 1 Securities will not be entitled to that interest payment (or if LBG elects to make a payment of a portion, but not all, of such interest payment, the portion of such interest payment not paid) on the relevant Interest Payment Date.

The interest rate on the Additional Tier 1 Securities will be reset on each Reset Date, which may affect the market value of the Additional Tier 1 Securities.

The Additional Tier 1 Securities will initially earn interest at a fixed rate of % per annum to, but excluding, the First Call Date. From, and including, the First Call Date, however, and every Reset Date thereafter, the interest rate will be reset to a rate per annum which will equal the aggregate of % and the then-prevailing Mid-Market Swap Rate (as defined under "*Description of the Additional Tier 1 Securities—Payments—Interest Rate*"). This reset rate could be less than the initial interest rate and/or the interest rate that applies immediately prior to such Reset Date, which could affect the amount of any interest payments under the Additional Tier 1 Securities and so the market value of an investment in the Additional Tier 1 Securities.

LBG's obligations under the Additional Tier 1 Securities are subordinated and will be further subordinated upon Automatic Conversion into Settlement Shares.

LBG's obligations under the Additional Tier 1 Securities will be unsecured and subordinated and will rank junior in priority of payment to the current and future claims of all of its senior and certain of its subordinated creditors. If a Winding-up or Administration Event (as defined under "*Description of the Additional Tier 1 Securities—Ranking and Liquidation Distribution*") occurs prior to the date on which a Trigger Event occurs, LBG will pay each holder of an Additional Tier 1 Security an amount that would have been payable if, throughout the Winding-up or Administration Event, such holder of an Additional Tier 1 Security had been the holder of a class of LBG's preference shares having an equal right to a return of assets in the Winding-up or Administration Event to, and so ranking *pari passu* with, the holders of the most senior class or classes of LBG's issued preference shares in the capital of LBG from time to time (if any) and which have a preferential right to a return of assets in the Winding-up or Administration Event over, and so rank ahead of, the holders of all other classes of issued shares for the time being in the capital of LBG but ranking junior to the claims of Senior Creditors (as defined under "*Description of the Additional Tier 1 Securities—Ranking and Liquidation Distribution*"). If a Winding-up or Administration Event occurs at any time on or following the date on which a Trigger Event occurs but the Settlement Shares to be issued and delivered to the Settlement Share Depository on the Conversion Date have not been so delivered, LBG shall pay such amount, if any, as would have been payable to a holder of an Additional Tier 1 Security in a Winding-up or Administration Event if the Conversion Date had occurred immediately before the occurrence of a Winding-up or Administration Event and, accordingly, as if such holder were, throughout such Winding-up or Administration Event, the holder of such number of Ordinary Shares as it would have been entitled to receive upon Automatic Conversion, regardless of whether the Solvency Condition had been satisfied on such date and ignoring for this purpose LBG's right to make an election for a Settlement Shares Offer to be effected.

Subject to complying with applicable regulatory requirements, LBG expects from time to time to incur additional indebtedness or other obligations that will constitute senior and subordinated indebtedness, and the Additional Tier 1 Securities do not contain any provisions restricting the ability of LBG or its subsidiaries to incur senior or subordinated indebtedness. Although the Additional Tier 1 Securities may (subject to cancellation as provided above) pay a higher rate of interest than comparable securities which are not so subordinated, there is a real risk that an investor in the Additional Tier 1 Securities will lose all or some of its investment should LBG become insolvent since its assets would be available to pay such amounts only after all of its senior and more senior subordinated creditors have been paid in full.

Therefore, if a Winding-up or Administration Event were to occur, the LBG liquidator or administrator would first apply assets of LBG to satisfy all rights and claims of Senior Creditors. If LBG does not have sufficient assets to settle claims of such Senior Creditors in full, the claims of the holders of the Additional Tier 1 Securities will not be settled and, as a result, holders of the Additional Tier 1 Securities will lose the entire amount of their investment in the Additional Tier 1 Securities. The Additional Tier 1 Securities will share equally in payment with claims under Parity Securities (or, with claims in respect of Ordinary Shares, in the event of a Winding-up or Administration Event occurring in the intervening period between a Trigger Event and the Conversion Date) if LBG does not have

sufficient funds to make full payments on all of them, as applicable. In such a situation, holders of the Additional Tier 1 Securities could lose all or part of their investment.

In addition, investors should be aware that, upon the occurrence of the Automatic Conversion of the Additional Tier 1 Securities following a Trigger Event, holders will be, effectively, further subordinated as they will be treated as, and subsequently become, holders of Ordinary Shares, even if existing subordinated indebtedness and preference shares remain outstanding. There is a risk that holders will lose the entire amount of their investment, regardless of whether LBG has sufficient assets available to settle what would have been the claims of holders of the Additional Tier 1 Securities or of securities subordinated to the same or greater extent as the Additional Tier 1 Securities, in winding-up proceedings or otherwise.

Under the terms of the Additional Tier 1 Securities, you have agreed to be bound by the exercise of any U.K. bail-in power imposed by the relevant U.K. resolution authority.

Notwithstanding any other agreements, arrangements, or understandings between us and any holder or beneficial owner of the Additional Tier 1 Securities, the holders and beneficial owners of the Additional Tier 1 Securities will be required to agree that by purchasing or acquiring the Additional Tier 1 Securities, they acknowledge, accept, agree to be bound by and consent to the exercise of any U.K. bail-in power by the relevant U.K. resolution authority that may result in (i) the reduction or cancellation of all, or a portion, of the principal amount of, or interest on, the Additional Tier 1 Securities; (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Additional Tier 1 Securities into shares or other securities or other obligations of LBG or another person; and/or (iii) the amendment or alteration of the maturity of the Additional Tier 1 Securities, or amendment of the amount of interest due on the Additional Tier 1 Securities, or the dates on which interest becomes payable, including by suspending payment for a temporary period; any U.K. bail-in power may be exercised by means of variation of the terms of the Additional Tier 1 Securities solely to give effect to the exercise by the relevant U.K. resolution authority of such U.K. bail-in power. Each holder and beneficial owner of the Additional Tier 1 Securities will further be required to acknowledge and agree that the rights of the holders and/or beneficial owners under the Additional Tier 1 Securities are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority. See "*—Holders of the Additional Tier 1 Securities may be required to absorb losses in the event we become subject to recovery and resolution action*".

For these purposes, a "U.K. bail-in power" is any write-down, conversion, transfer, modification or suspension power existing from time to time under any laws, regulations, rules or requirements relating to the resolution of banks, banking group companies, credit institutions and/or investment firms incorporated in the United Kingdom in effect and applicable in the United Kingdom to LBG or its affiliates, including but not limited to any such laws, regulations, rules or requirements which are implemented, adopted or enacted within the context of a European Union directive or regulation of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and/or within the context of a U.K. resolution regime under the Banking Act as the same has been or may be amended from time to time (whether pursuant to the Banking Reform Act 2013, secondary legislation or otherwise), pursuant to which any obligations of a bank, banking group company, credit institution or investment firm or any of its affiliates can be reduced, canceled, modified, transferred and/or converted

into shares or other securities or obligations of the obligor or any other person (or suspended for a temporary period) or pursuant to which any right in a contract governing such obligations may be deemed to have been exercised. A reference to the "relevant U.K. resolution authority" is to any authority with the ability to exercise a U.K. bail-in power. For more information, see "*Description of the Additional Tier 1 Securities—Agreement with Respect to the Exercise of U.K. Bail-in Powers*".

Holders of the Additional Tier 1 Securities may be required to absorb losses in the event we become subject to recovery and resolution action.

The BRRD, establishing a framework for the prevention, management and resolution of failing banks entered into force in 2014. In the U.K., the Banking Reform Act 2013 made provision for certain aspects of the "bail-in" power and further legislation was enacted during 2014 in order to give full effect to the majority of the provisions of BRRD from January 1, 2015.

The stated aim of the BRRD is to provide authorities designated by Member States to apply the resolution tools and exercise the resolution powers set forth in the BRRD (the "resolution authorities") with common tools and powers to address banking crises pre-emptively in order to safeguard financial stability and minimize taxpayers'

exposure to losses. The powers granted to resolution authorities under the BRRD include (but are not limited to) (i) a "write-down and conversion power" relating to Tier 1 and Tier 2 capital instruments (including the Additional Tier 1 Securities) and (ii) a "bail-in" power relating to eligible liabilities (including the Additional Tier 1 Securities). Such powers give resolution authorities the ability to write down or write off all or a portion of the claims of certain unsecured creditors of a failing institution or group and/or to convert certain debt claims into another security, including ordinary shares of the surviving group entity, if any, which ordinary shares may also be subject to write-down or write-off. Such powers were implemented with effect from January 1, 2015.

The conditions for use of the bail-in power are, in summary, that (i) the regulator determines that the bank is failing or likely to fail, (ii) having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilization powers) action will be taken by or in respect of the bank to avoid the failure of the bank, (iii) the relevant U.K. resolution authority determines that it is necessary having regard to the public interest to exercise the bail-in power in the advancement of one of the statutory objectives of resolution and (iv) that one or more of those objectives would not be met to the same extent by the winding up of the bank. The BRRD, as implemented, contains certain other limited safeguards for creditors in specific circumstances which (a) in the case of the write-down and conversion power, may provide compensation to holders of the relevant capital instruments via the issue or transfer of ordinary shares or other equity securities of the bank or its parent undertaking in certain circumstances and (b) in the case of senior creditors, aim to ensure that they do not incur greater losses than they would have incurred had the relevant financial institution been wound up under normal insolvency proceedings.

As the parent company of a U.K. bank, we are subject to the "Special Resolution Regime" under the Banking Act, that gives wide powers in respect of U.K. banks and their parent and other group companies to HM Treasury, the Bank of England (including the Prudential Regulation Authority (the "**PRA**")), and the **FCA** in circumstances where a U.K. bank has encountered or is likely to encounter financial difficulties.

In addition to the BRRD described above, it is possible that the exercise of other powers under the U.K. Banking Act, to resolve failing banks in the United Kingdom and give the authorities powers to override events of default or termination rights that might be invoked as a result of the exercise of the resolution powers, could have a material adverse effect on the rights of holders of the Additional Tier 1 Securities, including through a material adverse effect on the price of the Additional Tier 1 Securities. The Banking Act also gives the Bank of England the power to override, vary or impose contractual obligations between a U.K. bank, its holding company and its group undertakings for reasonable consideration, in order to enable any transferee or successor bank to operate effectively. There is also power for the U.K. Treasury to amend the law (excluding provisions made by or under the Banking Act) for the purpose of enabling it to use the regime powers effectively, potentially with retrospective effect. In addition, the Banking Act may be further amended and/or other legislation may be introduced in the United Kingdom to amend the resolution regime that would apply in the event of a bank failure or to provide regulators with other resolution powers.

Finally, the determination that all or part of the principal amount of Additional Tier 1 Securities will be subject to bail-in is likely to be inherently unpredictable and may depend on a number of factors which may be outside of our control. For the avoidance of doubt, the potential Automatic Conversion of the Additional Tier 1 Securities into Settlement Shares, other securities or other obligations in connection with the exercise of any U.K. Bail-in Power by

the relevant UK Resolution Authority is separate and distinct from the Automatic Conversion pursuant to the terms and conditions of the Additional Tier 1 Securities following a Trigger Event. This determination will also be made by the relevant U.K. resolution authority and there may be many factors, including factors not directly related to us or the Group, which could result in such a determination. Because of this inherent uncertainty, it will be difficult to predict when, if at all, the exercise of a U.K. bail-in power may occur which would result in a principal write-off or conversion to other securities, including equity. Moreover, as the criteria that the relevant U.K. resolution authority will be obliged to consider in exercising any U.K. bail-in power provide it with considerable discretion, holders of the Additional Tier 1 Securities may not be able to refer to publicly available criteria in order to anticipate a potential exercise of any such power and consequently its potential effect on us, the Group and the Additional Tier 1 Securities. Potential investors in the Additional Tier 1 Securities should consider the risk that a holder may lose all of its investment, including the principal amount plus any accrued interest, if such statutory loss absorption measures are acted upon.

Holders of Additional Tier 1 Securities may have limited rights or no rights to challenge any decision of the relevant U.K. resolution authority to exercise the U.K. bail-in power or to have that decision reviewed by a judicial or administrative process or otherwise.

Accordingly, trading behavior in respect of the Additional Tier 1 Securities is not necessarily expected to follow the trading behavior associated with other types of securities that are not subject to such recovery and resolution powers. Potential investors in the Additional Tier 1 Securities should consider the risk that a holder of the Additional Tier 1 Securities may lose all of its investment, including the principal amount plus any accrued and unpaid interest, if such statutory loss absorption measures are acted upon or that the Additional Tier 1 Securities may be converted into ordinary shares. Further, the introduction or amendment of such recovery and resolution powers, and/or any implication or anticipation that they may be used, may have a significant adverse effect on the market price of the Additional Tier 1 Securities, even if such powers are not used.

Your rights may be limited in respect of the exercise of the U.K. bail-in power by the relevant U.K. resolution authority.

There may be limited protections, if any, that will be available to holders of securities subject to the U.K. bail-in power (including the Additional Tier 1 Securities) and to the broader resolution powers of the relevant U.K. resolution authority. For example, although under the Banking Act the Bank of England's resolution instrument with respect to the exercise of the bail-in tool must set out the provisions allowing for securities to be transferred, canceled or modified (or any combination of these), the resolution instrument may make any other provision that the Bank of England considers to be appropriate in exercising its specific powers. Such other provisions are expected to be specific and tailored to the circumstances that have led to the exercise of the bail-in tool under the Banking Act and there is uncertainty as to the extent to which usual processes or procedures under English law will be available to holders of securities (including the Additional Tier 1 Securities). Accordingly, you may have limited or circumscribed rights to challenge any decision of the Bank of England or other relevant U.K. resolution authority to exercise its U.K. bail-in power.

Other powers contemplated by the Banking Act may affect your rights under, and the value of your investment in, the Additional Tier 1 Securities.

In addition to the capital instruments write-down and conversion power and the bail-in tool, the Banking Act includes powers to (a) transfer all or some of the securities issued by a U.K. bank or its parent, or all or some of the property, rights and liabilities of a U.K. bank or its parent (which would include the Additional Tier 1 Securities), to a commercial purchaser or, in the case of securities, into temporary public ownership (to HM Treasury or an HM Treasury nominee), or, in the case of property, rights or liabilities, to a bridge bank (an entity owned by the Bank of England) (b) together with another resolution tool only, transfer impaired or problem assets to one or more publicly owned asset management vehicles to allow them to be managed with a view to maximizing their value through eventual sale or orderly wind-down (c) override any default provisions, contracts or other agreements, including provisions that would otherwise allow a party to terminate a contract or accelerate the payment of an obligation (d) commence certain insolvency procedures in relation to a U.K. bank and (e) override, vary or impose contractual obligations, for reasonable consideration, between a U.K. bank or its parent and its group undertakings (including undertakings which have ceased to be members of the group), in order to enable any transferee or successor bank of the U.K. bank to operate effectively.

The Banking Act also gives power to HM Treasury to make further amendments to the law for the purpose of enabling it to use these powers effectively, potentially with retrospective effect.

The powers set out in the Banking Act could affect how credit institutions (and their parent companies) and investment firms are managed as well as, in certain circumstances, the rights of creditors. Accordingly, the taking of any actions contemplated by the Banking Act may affect your rights under the Additional Tier 1 Securities, and the value of your Additional Tier 1 Securities may be affected by the exercise of any such powers or threat thereof.

The circumstances under which the relevant U.K. resolution aubsp; *Research and development expenses*

	Quarter ended			**% Variation**	
	Dec 31, 2005	**Oct 1, 2005**	**Dec 31, 2004**	**Sequential**	**Year-over-year**
		(in millions)			
Research and development expenses	$ (402)	$ (401)	$ (402)	(0.1%)	0.1%
As percentage of net revenues	(16.8%)	(17.9%)	(17.3%)		

On a year-over-year basis as well as on a sequential basis, our research and development expenses remained flat. Our research and development expenses of the fourth quarter 2005 included $3 million in share-based compensation costs for our employees. Excluding these items, our research and development expenses decreased sequentially mainly due to the seasonal effect and the positive impact of the U.S. dollar exchange rate. The foregoing impacts translated into a sequential decrease in research and development expenses as a percentage of net revenues.

Other income and expenses, net

	Quarter ended		
	Dec 31, 2005	Oct. 1, 2005	Dec 31, 2004
		(in millions)	
Research and development funding	$ 29	$ 20	$ 47
Start-up costs	(10)	(12)	(18)
Exchange gain (loss) net	(20)	(5)	14
Patent claim costs	(6)	(6)	(16)
Gain on sale of non-current assets	8	(2)	
Other, net	1	2	(4)
Other income and expenses, net	**2**	**(3)**	**23**
As a percentage of net revenues	0.1%	(0.1%)	1.0%

Other income and expenses, net results include miscellaneous items such as research and development funding, gains on sale of non-current assets and as expenses it mainly includes start-up costs, net exchange losses and patent claim costs. In the fourth quarter 2005, research and development funding income was associated to our research and development projects, which qualify as funding on the basis of contracts with local government agencies in locations where we pursue our activities. The net gain on sale of non-current assets of $8 million is the result of the gains on sales of real estate properties in India and of certain equipment in other countries. Start-up costs were related to our conversion to 200-mm fab in Agrate (Italy), to the build-up of the 300-mm fab in Catania (Italy) and to the 150-mm fab expansion in Singapore. The net exchange loss related to transactions not designated as a cash flow hedge denominated in foreign currencies. Patent claim costs included costs associated with several ongoing litigations and claims; these costs are categorized either as patent litigation costs or pre-litigation costs, amounting to $3 million and $3 million, respectively.

Impairment, restructuring charges and other related closure costs

	Quarter ended		
	Dec 31, 2005	Oct 1, 2005	Dec 31, 2004
		(in millions)	
Impairment, restructuring charges and other related closure costs	$ (16)	$ (12)	$ (18)
As a percentage of net revenues	(0.7%)	(0.5)%	(0.8%)

Our impairment, restructuring charges and other related closure costs of $16 million for the fourth quarter of 2005 were composed of:

Our new headcount restructuring plan announced in May 2005, which resulted in charges of $17 million mainly for employee termination benefits;

Our restructuring and reorganization activities initiated in the first quarter of 2005, which generated an additional charge of $1 million; and

Our ongoing 2003 restructuring plan and related manufacturing initiatives generated a positive impact of approximately $2 million as a result of a reversal of a provision pursuant to our decision made in the fourth quarter 2005 to keep a back-end production line in France.

See Note 18 to our Consolidated Financial Statements.

Operating income

	Quarter ended		
	Dec 31, 2005	Oct 1, 2005	Dec 31, 2004
	(in millions)		
Operating income	$ 197	$ 102	$ 210
In percentage of net revenues	8.2%	4.5%	9.0%

Our operating income decreased on a year-over-year basis mainly due the negative impact of the ongoing pricing pressure on our net revenues and the increase in our total operating expenses mainly related to higher selling, general and administrative expenses and lower other incomes. These negative factors were

partially compensated by overall improved efficiencies in our manufacturing activities and higher volume of sales.

With respect to our product segments, on a year-over-year basis, only MPG registered an improvement in its operating income. ASG registered a decrease from $157 million compared to its operating income of $137 million in the fourth quarter of 2004, due to the negative impact of ongoing pricing pressure, lower sales and the negative impact of the effective U.S. dollar exchange rate. MLD operating income decreased from $105 million in the fourth quarter of 2004 to $67 million in the fourth quarter of 2005 due to continuing price pressure and increased operating expenses, while sales remained flat. In the fourth quarter of 2005, MPG registered an operating income of $27 million, compared to an operating income of $4 million in the fourth quarter of 2004, mainly due to significant increases in revenues and improved product mix.

On a sequential basis, the main contributors to the increase of our operating income, in addition to currency benefits, were higher sales volumes, improved product mix and manufacturing efficiencies that more than compensated for the further decline in our selling prices.

On a sequential basis, with respect to our three product segments, ASG reached a double-digit operating margin, MLD maintained a nearly 14% margin level sequentially notwithstanding tougher market conditions and as expected MPG generated an operating profit. ASG improved its operating income in the fourth quarter of 2005 to $137 million compared to $81 million in the third quarter 2005; ASG profitability benefited from higher sales and better product mix. MPG was able to move from its operating loss of $17 million in the third quarter of 2005 to an operating income of $27 million mainly due to higher sales, better product mix and improved manufacturing performances. MLD operating income in the fourth quarter 2005 was $67 million compared to $68 million in the third quarter of 2005; despite tougher pricing conditions, MLD maintained its profitability by achieving higher sales.

Interest income, net

	Quarter ended		
	Dec 31, 2005	Oct 1, 2005	Dec 31, 2004
	(in millions)		
Interest income, net	$ 11	$ 8	$ 5

Our interest income increased both year-over-year and sequentially. The year-over-year improvement reflects the decrease in interest expense due to our repurchases of our 2010 Bonds. In addition, the interest rate on our cash and cash equivalents has improved from approximately 2.3% at the end of the fourth quarter of 2004 to 4.1% at the end of the fourth quarter 2005.

Loss on equity investments

	Quarter ended		
	Dec 31, 2005	Oct 1, 2005	Dec 31, 2004
	(in millions)		
Loss on equity investments		$ (2)	$ (2)

We did not record any major variation in the fourth quarter of 2005 in relation to our investments. Our current major investment is as a minority shareholder in our joint venture in China with Hynix Semiconductor Inc., which is in a start-up phase. In the fourth quarter of 2004, we recorded a $2 million charge corresponding to the loss in the equity value of our shareholding in UPEK Inc.

Income tax benefit (expense)

	Quarter ended		
	Dec 31,	Oct 1, 2005	Dec 31, 2004

	2005		
		(in millions)	
Income tax expense	$ (25)	$ (18)	$ (26)

During the fourth quarter of 2005, we incurred an income tax expense of $25 million as the result of actual tax charges in each jurisdiction for the total year.

Our effective tax rate was 12.1% in the fourth quarter of 2005, compared to 17.0% in the third quarter of 2005 and compared to 12.3% in the fourth quarter of 2004. The effective tax rate for the fourth quarter of

2005 was prorated on the basis of actual tax charges in each jurisdiction. Our tax rate is variable and depends on changes in the level of operating income within various local jurisdictions and on changes in the applicable taxation rates of these jurisdictions, as well as changes in estimated tax provisions due to new events. We currently enjoy certain tax benefits in some countries; as such benefits may not be available in the future due to changes in the local jurisdictions, our effective tax rate could be different in future quarters and may increase in the coming years.

Net income

	Quarter ended		
	Dec 31, 2005	Oct 1, 2005	Dec 31, 2004
		(in millions)	
Net income	$ 183	$ 89	$ 187
As percentage of net revenues	7.7%	3.9%	8.0%

For the fourth quarter of 2005, we reported net income of $183 million, significantly improving compared to $89 million in the third quarter of 2005, and basically flat compared to net income of $187 million in the fourth quarter of 2004, however declining to 7.7% of the net revenues on a year-over-year basis. Basic and diluted earnings per share for the fourth quarter of 2005 were both $0.20, comparable to the fourth quarter of 2004 with $0.21 and $0.20 respectively, and improved compared to the basic and diluted earnings of $0.10 per share for the third quarter of 2005.

Impact of Changes in Exchange Rates

Our results of operations and financial condition can be significantly affected by material changes in exchange rates between the U.S. dollar and other currencies where we maintain our operations, particularly the euro, the Japanese yen and other Asian currencies.

As a market rule, the reference currency for the semiconductor industry is the U.S. dollar and product prices are mainly denominated in U.S. dollars. However, revenues for certain of our products (primarily dedicated products sold in Europe and Japan) that are quoted in currencies other than the U.S. dollar are directly affected by fluctuations in the value of the U.S. dollar. As a result of the currency variations, the appreciation of the euro compared to the U.S. dollar could increase in the short term our level of revenues when reported in U.S. dollars; revenues for all other products, which are either quoted in U.S. dollars and billed in U.S. dollars or in local currencies for payment, tend not to be affected significantly by fluctuations in exchange rates, except to the extent that there is a lag between changes in currency rates and adjustments in the local currency equivalent price paid for such products. Furthermore, certain significant costs incurred by us, such as manufacturing, labor costs and depreciation charges, selling, general and administrative expenses, and research and development expenses, are largely incurred in the currency of the jurisdictions in which our operations are located, given that most of our operations are located in the euro zone or other currency areas: as such they tend to increase when translated in U.S. dollars in case of dollar rate weakening or to reduce when the dollar rate is strengthening.

Because our reporting currency is the U.S. dollar, currency exchange rate fluctuations affect our results of operations because we receive a limited part of our revenues, and more importantly, incur the majority of our costs, in currencies other than the U.S. dollar. In 2005, the U.S. dollar declined in value, particularly against the euro, causing us to report higher expenses and negatively impacting both our gross margin and operating income. Our Consolidated Statement of Income for the year ended December 31, 2005 includes income and expense items translated at the average exchange rate for the period.

Our principal strategy to reduce the risks associated with exchange rate fluctuations has been to balance as much as possible the proportion of sales to our customers denominated in U.S. dollars with the amount of raw materials, purchases and services from our suppliers denominated in U.S. dollars, thereby reducing the potential exchange rate impact of certain variable costs relative to revenues. Moreover, in order to further reduce the exposure to U.S. dollar exchange fluctuations, we have hedged certain line items on our income statement, in particular with respect to a portion of cost of goods sold, most of the research and development expenses and certain selling and general and

administrative expenses, located in the euro zone. Our effective average rate of the euro to the U.S. dollar was $1.28 for 1.00 in 2005 and it was $1.23 for 1.00 in 2004. These effective exchange rates reflect the actual exchange rates combined with the impact of hedging contracts matured in the period.

As of December 31, 2005, the outstanding hedged amounts to cover manufacturing costs were 380 million and to cover operating expenses were 310 million, at an average rate of about $1.205 and $1.20 per euro respectively, maturing over the period from January 2006 to June 2006. As of December 31, 2005, these hedging contracts represented a deferred loss of $13 million after tax, registered in other comprehensive income in shareholders equity, compared to a deferred gain of $59 million as of December 31, 2004. Our hedging policy is not intended to cover the full exposure. In addition, in order to mitigate potential exchange rate risks on our commercial transactions, we purchased and sold forward foreign currency exchange contracts and currency options to cover foreign currency exposure in payables or receivables at our affiliates. We may in the future purchase or sell similar types of instruments. For full details of outstanding contracts and their fair values, see Item 11. Quantitative and Qualitative Disclosures About Market Risk included in our Form 20-F, as may be updated from time to time in our public filings. Furthermore, we may not predict in a timely fashion the amount of future transactions in the volatile industry environment. Consequently, our results of operations have been and may continue to be impacted by fluctuations in exchange rates.

Our treasury strategies to reduce exchange rate risks are intended to mitigate the impact of exchange rate fluctuations. No assurance may be given that our hedging activities will sufficiently protect us against declines in the value of the U.S. dollar, therefore if the value of the U.S. dollar increases, we may record losses in connection with the loss in value of the remaining hedging instruments at the time. As a result of losses incurred in respect of hedging contracts in 2005, we recorded total charges of $81 million, consisting of charges of $51 million to cost of sales, $23 million to research and development expenses, and $7 million to selling, general and administrative expenses, while in 2004, we registered a total income of $16 million. As the result of the gains or losses on exchange on all the other transactions, in 2005, we registered a net loss of $16 million compared to a net gain of $33 million in 2004.

Assets and liabilities of subsidiaries are, for consolidation purposes, translated into U.S. dollars at the period-end exchange rate. Income and expenses are translated at the average exchange rate for the period. The balance sheet impact of such translation adjustments has been, and may be expected to be, significant from period to period since a large part of our assets and liabilities are accounted for in euro as their functional currency. Adjustments resulting from the translation are recorded directly in shareholders equity, and are shown as accumulated other comprehensive income (loss) in the consolidated statements of changes in shareholders equity. At December 31, 2005, our outstanding indebtedness was denominated principally in U.S. dollars and, to a limited extent, in euros and in Singapore dollars.

Effective January 1, 2006, we have changed the organization of our Corporate Treasury and, simultaneously, we have created a Treasury Committee to oversee our investment and foreign exchange operations.

For a more detailed discussion, see Item 3. Key Information Risk Factors Risks Related to Our Operations Our financial results can be adversely affected by fluctuations in exchange rates, principally in the value of the U.S. dollar as set forth in our Form 20-F.

Liquidity and Capital Resources

Treasury activities are regulated by our policies, which define procedures, objectives and controls. The policies focus on the management of our financial risk in terms of exposure to currency rates and interest rates. Most treasury activities are centralized, with any local treasury activities subject to oversight from our head treasury office. The majority of our cash and cash equivalents are held in U.S. dollars and are placed with financial institutions rated A or higher. Marginal amounts are held in other currencies. See Item 11. Quantitative and Qualitative Disclosures About Market Risk included in our Form 20-F, as may be updated from time to time in our public filings.

At December 31, 2005, cash and cash equivalents totaled $2,027 million, compared to $1,950 million as of December 31, 2004 and $2,998 million as of December 31, 2003. During 2005, we invested in credit-linked deposits issued by several primary banks in order to maximize the return on available cash. The principal was fully repaid to us in December 2005. We did not have marketable securities at December 31, 2005 as well as at December 31, 2004. Changes in the instruments adopted to invest our liquidity in future periods may occur and may significantly affect our interest income/(expense), net.

Liquidity

We maintain a significant cash position and a low debt to equity ratio, which provide us with adequate financial flexibility. As in the past, our cash management policy is to finance our investment needs mainly with net cash generated from operating activities.

Net cash from operating activities. As in prior periods, the major source of cash during 2005 was cash provided by operating activities. Our net cash from operating activities totaled $1,798 million in 2005, decreasing compared to $2,342 million in 2004 and $1,920 million in 2003.

Changes in our operating assets and liabilities resulted in net cash used of $472 million in 2005, compared to net cash used of $142 million in 2004. The main variations were due to the net cash used for inventory, and more cash was used for trade payables and for other assets and liabilities.

Net cash used in investing activities. Net cash used in investing activities was $1,528 million in 2005, compared to $2,134 million in 2004 and $1,439 million in 2003. Payments for purchases of tangible assets were the main utilization of cash, amounting to $1,441 million for 2005, a significant decrease over the $2,050 million in 2004. The 2005 payments are net of $82 million proceeds from equipment resale. In 2005, cash used for investments in intangible assets and financial assets was $49 million and capital contributions to equity investments was $38 million. There were no payments for acquisitions in 2005 compared to $3 million paid in 2004 relating to the portion of Synad Ltd. cash consideration.

Capital expenditures for 2005 were principally allocated to:

- the capacity expansion of our 200-mm and 150-mm front-end facilities in Singapore;
- the conversion to 200-mm of our front-end facility in Agrate (Italy);
- the capacity expansion of our back-end plants in Muar (Malaysia), Shenzhen (China), Toa Payoh (Singapore) and Malta;
- the expansion of our 200-mm front-end facility in Phoenix (Arizona);
- the capacity expansion of our 200-mm front-end facility in Rousset (France);
- the completion of building and continuation of facilities for our 300-mm front-end plant in Catania (Italy);
- the expansion of an 150-mm front-end and a 200-mm pilot line in Tours (France); and
- the expansion of the 300-mm front-end joint project with Philips Semiconductor International B.V. and Freescale Semiconductor Inc., in Crolles2 (France).

Capital expenditures for 2004 were principally allocated to:

- the expansion of our 200-mm and 150-mm front-end facilities in Singapore;
- the expansion of our 200-mm front-end facility in Rousset (France);
- the facilitization of our 300-mm facility in Catania (Italy);
- the upgrading of our front-end and research and development pilot line in Agrate (Italy);
- the upgrading of our 200-mm front-end facility in Catania (Italy);
- the expansion and upgrading of our front-end facilities 200-mm in Phoenix and 150-mm in Carrollton (United States); and
- the capacity expansion in our back-end plants of Muar (Malaysia), Toa Payoh (Singapore), Shenzen (China) and Malta.

Capital expenditures for 2003 were principally allocated to:

- the expansion of our 200-mm and 150-mm front-end facilities in Singapore;
- the upgrading of our 200-mm front-end plant in Agrate (Italy);

the expansion of our 200-mm front-end facility in Rousset (France);

the expansion of our 300-mm facility in Crolles2 (France);

the facilitization of our 300-mm facility in Catania (Italy); and

the expansion of our back-end facilities in Muar (Malaysia).

Net operating cash flow. We define net operating cash flow as net cash from operating activities minus net cash used in investing activities, excluding payment for purchases of and proceeds from the sale of marketable securities. We believe net operating cash flow provides useful information for investors because it measures our capacity to generate cash from our operating activities to sustain our investments for our operating activities. Net operating cash flow is not a U.S. GAAP measure and does not represent total cash flow since it does not include the cash flows generated by or used in financing activities. In addition, our definition of net operating cash flow may differ from definitions used by other companies. Net operating cash flow is determined as follows from our Consolidated Statements of Cash Flow:

	Year ended December 31,		
	2005	2004	2003
		(in millions)	
Net cash from operating activities	1,798	$ 2,342	$ 1,920
Net cash used in investing activities.	(1,528)	(2,134)	(1,439)
Payment for purchase and proceeds from sale of marketable securities, net			(4)
Net operating cash flow	**$ 270**	**$ 208**	**$ 477**

Due to the capacity of our operating activities to generate cash in excess of our investing activities, we generated net operating cash flow of $270 million in 2005, compared to net operating cash flow of $208 million in 2004. This resulted mainly from the decrease in net cash used in investing activities. In 2003, we generated a net operating cash flow of $477 million.

Net cash used in financing activities.?Net cash used in financing activities was $178 million in 2005 compared to $1,271 million in 2004. The major item of the cash used in 2005 was the payment of the dividends amounting to $107 million, equivalent to the amount paid in 2004 while the amount paid in 2003 was $71 million. The major item of the cash used for financing activities in 2004 was the repayment of long-term debt for a total amount of $1,288 million, mainly consisting of the redemption of all outstanding 2009 LYONs for an amount paid of $813 million and of the repurchase of all outstanding 2010 Bonds for an amount paid of $375 million. These bonds were cancelled. During 2003, we received proceeds from issuance of long-term debt of $1,398 million, mainly related to the offering of our 2013 Bonds, and we repaid $1,432 million mainly related to repurchases of our 2010 Bonds.

Capital Resources

Net financial position

We define our net financial position as the difference between our total cash position (cash and cash equivalents) net of total financial debt (bank overdrafts, current portion of long-term debt and long-term debt). Net financial position is not a U.S. GAAP measure. We believe our net financial position provides useful information for investors because it gives evidence of our global position either in terms of net indebtedness or net cash by measuring our capital resources based on cash and cash equivalents and the total level of our financial indebtedness. The net financial position is determined as follows from our Consolidated Balance Sheets as at December 31, 2005, December 31, 2004 and December 31, 2003:

	Year ended December 31,		
	2005	2004	2003
		(in millions)	
Cash and cash equivalents	$ 2,027	$ 1,950	$ 2,998
Marketable securities			
Total cash position	2,027	1,950	2,998
Bank overdrafts	(11)	(58)	(45)
Current portion of long-term debt	(1,522)	(133)	(106)
Long-term debt	(269)	(1,767)	(2,944)
Total financial debt	(1,802)	(1,958)	(3,095)
Net financial position	$ 225	$ (8)	$ (97)

The net financial position (cash and cash equivalents net of total financial debt) as of December 31, 2005 moved to a positive net financial cash position of $225 million, representing an improvement from the net financial debt

position of $8 million as of December 31, 2004. The improvement of the net financial position mainly results from favorable net operating cash flow generated during 2005.

At December 31, 2005, the aggregate amount of our long-term debt was approximately $1,791 million, including $1,379 million of 2013 Bonds. At the holder s option, any outstanding 2013 Bond may be redeemed for cash on August 5, 2006, 2008 or 2010 for a total aggregate amount payable by us of $1,379 million on August 5, 2006 or $1,365 million on August 5, 2008 or $1,352 million on August 5, 2010. As a result of this holder s redemption option on August 5, 2006, the outstanding amount of 2013 Bonds was classified in the consolidated balance sheet as current portion of long-term debt . Additionally, the aggregate amount of our short-term credit facilities was approximately $1,957 million, under which approximately $11 million of indebtedness was outstanding. Our long-term financing instruments contain standard covenants, but do not impose minimum financial ratios or similar obligations on us. See Note 14 to our Consolidated Financial Statements.

As of December 31, 2005, debt payments due by period and based on the assumption that convertible debt redemptions are at the holder s first redemption option, were as follows:

	Payments due by period						
	Total	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**
				(in millions)			
Long-term debt (including current portion)	**1,791**	1,522	119	58	30	22	40
Average interest rate	**0.25%**	(0.19)%	3.14%	3.58%	2.49%	2.09%	1.16%

During 2004, we redeemed all the outstanding 2009 LYONs for a total amount of $813 million in cash.

In 2003, we repurchased approximately $1,674 million aggregate principal amount at maturity of our 2010 Bonds, for a total cash amount of approximately $1,304 million, representing approximately 78% of the total amount initially issued. In 2004, we repurchased all of our remaining outstanding 2010 Bonds for a total cash amount paid of $375 million. The repurchased 2010 Bonds were cancelled.

As of the end of 2005, we have the following credit ratings on our remaining convertible debt:

	Moody s Investors Service	**Standard & Poor s**
Zero Coupon Senior Convertible Bonds due 2013	A3	A

On October 11, 2005, Moody s issued a credit report confirming the above rating and updating the outlook from stable to negative .

In the event of a downgrade of these ratings, we believe we would continue to have access to sufficient capital resources.

Zero Coupon Senior Convertible Bonds due 2016

On February 15, 2006, we launched an offering of senior zero-coupon convertible bonds totalling gross proceeds of $928 million bearing an interest rate of 1.5%. We have granted an option to increase the issue size by up to 5% for a period of 30 days from settlement. Assuming full exercise of this option, gross proceeds from the offering will be up to $974 million. The notes are convertible into a maximum of 42 million of our underlying common shares, including the increase option. The conversion price is $23.19, based on the closing price of common shares on New York Stock Exchange on February 14, 2006, plus a 30% premium.

Contractual Obligations, Commercial Commitments and Contingencies

Our contractual obligations, commercial commitments and contingencies as of December 31, 2005, and for each of the five years to come and thereafter, were as follows:

	Total	2006	2007	2008	2009	2010	Thereafter
				(in millions)			
Capital leases[2]	$ 26	$ 5	$ 5	$ 5	$ 5	$ 5	$ 1
Operating leases[1]	271	50	37	32	28	22	102
Purchase obligations[1]	1,053	940	79	34			
of which:							
Equipment purchase	*576*	*576*					
Foundry purchase	*260*	*260*					
Software, technology licenses and design	*217*	*104*	*79*	*34*			
Joint Venture Agreement with Hynix Semiconductor Inc.[1][4]	212	212					
Other Obligations[1]	112	59	44	3	2	1	3
Long-term debt obligations (including current portion)[2][3]	1,791	1,522	119	58	30	22	40
Pension obligations[2].	270	29	20	22	26	28	145
Other non-current liabilities[2]	16	3	2	3	2	3	3
Total	**$ 3,751**	**$ 2,820**	**$ 306**	**$ 157**	**$ 93**	**$ 81**	**$ 294**

(1) Items not reflected on the Consolidated Balance Sheet at December 31, 2005.

(2) Items reflected on Consolidated Balance Sheet at December 31, 2005.

(3) See Note 14 to our Consolidated Financial Statements at December 31, 2005 for additional information related to long-term debt and redeemable convertible securities, in particular, in respect to the noteholders option to put our convertible bonds for earlier redemption in August 2006.

(4) These amounts correspond to our capital commitments to the joint venture, but not the additional $250 million in loans that we have committed to provide.

Operating leases are mainly related to building leases. The amount disclosed is composed of minimum payments for future leases from 2006 to 2010 and thereafter. We lease land, buildings, plants and equipment under operating leases that expire at various dates under non-cancelable lease agreements.

Purchase obligations are primarily comprised of purchase commitments for equipment, for outsourced foundry wafers and for software licenses.

We signed a joint venture agreement with Hynix Semiconductor Inc., on November 16, 2004 to build a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China. As the business license for the joint venture was obtained in April 2005, we paid $38 million of capital contributions up to December 31, 2005. We expect to fulfill our remaining financial obligations up to our total contribution of $250 million in 2006. In addition, we are committed to grant long-term financing for $250 million to the new joint venture guaranteed by subordinated collateral on the joint venture s assets. Furthermore, we have contingent future loading obligations to purchase products from the joint venture, which have not been included in the table above because, at this stage, the amounts remain contingent and non-quantifiable.

Long-term debt obligations mainly consist of bank loans and convertible debt issued by us that is totally or partially redeemable for cash at the option of the holder. They include maximum future amounts that may be redeemable for cash at the option of the holder, at fixed prices. At the holder s option, any outstanding 2013 Bond may be redeemed for cash on August 5, 2006, 2008 or 2010 for a total aggregate amount payable by us of $1,379 million on August 5, 2006 or $1,365 million on August 5, 2008 or $1,352 million on August 5, 2010. The conversion ratio is $985.09 per $1,000 principal amount of 2013 Bonds at August 5, 2006, $975.28 at August 5, 2008 and $965.56 at August 5, 2010, subject to adjustments in certain circumstances. As a result of this holder s redemption option in August 2006, the outstanding amount of 2013 Bonds was classified in the consolidated balance sheet as current portion of long-term debt at December 31, 2005.

Pension obligations amounting to $270 million consist of our best estimates of the amounts that will be payable by us for the retirement plans based on the assumption that our employees will work for us until they reach the age of retirement. The final actual amount to be paid and related timings of such payments may vary significantly due to early retirements or terminations. This amount does not include the additional pension plan for a total of $11 million granted by our Supervisory Board to our former CEO, to a limited number of retired senior executives in the first quarter of 2005 and to our executive management in the fourth quarter of 2005, which was recorded as current liabilities as we are intending to transfer this obligation to an insurance company. We accrued the estimated premiums to expenses during 2005.

Other non-current liabilities include future obligations related to our restructuring plans and miscellaneous contractual obligations.

Other obligations primarily relate to contractual firm commitments with respect to cooperation agreements.

Other than those described above, there are no material off-balance sheet obligations, contractual obligations or other commitments.

Financial Outlook

We currently expect that capital spending for 2006 will be approximately $1.8 billion, an increase compared to the $1.4 billion spent in 2005. The major part of our capital spending will be dedicated to the leading edge technology fabs by increasing capacity in the 300-mm and for saturation of the existing 200-mm. We have the flexibility to modulate our investments up or down in response to changes in market conditions. At December 31, 2005, we had $576 million in outstanding commitments for equipment purchases for 2006.

The most significant of our 2006 capital expenditure projects are expected to be: for the front-end facilities, (i) the expansion of the 300-mm front-end joint project with Philips Semiconductor International B.V. and Freescale Semiconductor Inc., in Crolles 2 (France); (ii) the preliminary equipment installation in our 300-mm plant in Catania (Italy); (iii) the upgrading to finer geometry technologies for our 200-mm plant in Rousset (France); (iv) the upgrading of our 200-mm plant in Singapore; (v) the upgrading of our 200-mm fab and pilot line in Agrate (Italy); and (vi) for the back-end facilities, the capital expenditures will be mainly dedicated to the capacity expansion in our plants in Shenzhen (China), Bouskoura (Morocco) and Muar (Malaysia). We will continue to monitor our level of capital spending by taking into consideration factors such as trends in the semiconductor industry, capacity utilization and announced additions. We expect to have significant capital requirements in the coming years and in addition we intend to continue to devote a substantial portion of our net revenues to research and development. We plan to fund our capital requirements from cash provided by operating activities, available funds and available support from third parties (including state support), and may have recourse to borrowings under available credit lines and, to the extent necessary or attractive based on market conditions prevailing at the time, the issuing of debt, convertible bonds or additional equity securities. A substantial deterioration of our economic results and consequently of our profitability could generate a deterioration of the cash generated by our operating activities. Therefore, there can be no assurance that, in future periods, we will generate the same level of cash as in the previous years to fund our capital expenditures for expansion plans, our working capital requirements, research and development and industrialization costs.

The holders of our 2013 Bonds may require us to redeem them on August 5, 2006 at a price of $985.09 per one thousand dollar face value. The conversion ratio is $985.09 per $1,000 principal amount of 2013 Bonds at August 5, 2006, $975.28 at August 5, 2008 and $965.56 at August 5, 2010, subject to adjustments in certain circumstances. The total redeemable amount will be equivalent to $1,379 million on August 5, 2006. There can be no assurance that additional financing will be available as necessary, or that any such financing, if available, will be on terms acceptable to us. However, we believe that our ability to meet debt obligations is fully backed by our existing liquidity and may be complemented by our cash flow plan and/or by accessing equity and/or debt capital markets.

Impact of Recently Issued U.S. Accounting Standards

In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* (FAS 151). The Statement requires abnormal amounts of idle capacity and spoilage costs to be excluded from the cost of inventory and expensed when incurred. The provisions of FAS 151 are applicable prospectively to inventory costs incurred during fiscal years beginning after June 15, 2005. We adopted early FAS 151 in 2005. As costs associated with underutilization of manufacturing facilities have historically been charged directly to cost of sales, FAS 151 has not had a material effect on our financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (FAS 153). This Statement amends Opinion No. 29 to eliminate the exception to the basic fair value measurement principle for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of transactions that do not have commercial substance, that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. The Statement is effective prospectively for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005, with early application permitted. We early adopted FAS 153 in 2005 but have not had any material nonmonetary exchanges of assets since FAS 153 was published. Therefore, FAS 153 has not had a material effect on our financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* and the related FASB Staff Positions (collectively FAS 123R). This Statement revises FASB Statement No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. FAS 123R requires a public entity to measure the cost of share-based service awards based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period, usually the vesting period. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. FAS 123R also requires more extensive disclosures than the previous standards relating to the nature of share-based payment transactions, compensation cost and cash flow effects. On April 14, 2005, the Securities and Exchange Commission amended the effective date of FAS 123R; the Statement now applies to all awards granted and to all unvested awards modified, repurchased, or cancelled during the first annual reporting period beginning after June 15, 2005. We are required to adopt FAS 123R in the first quarter of 2006 or earlier, and we elected an early adoption in the fourth quarter of 2005 using the modified prospective application method. In 2005, we redefined our equity-based compensation strategy in order to maintain a more effective policy in motivating and retaining key employees, by no longer granting options but rather issuing non-vested stock. As part of this revised stock compensation policy, we decided in July 2005 to accelerate the vesting period of outstanding unvested stock options, following authorization from our shareholders at the annual general meeting held on March 18, 2005. As a result, options equivalent to approximately 32 million shares became exercisable immediately. Based on the market value of our shares, all these options had no intrinsic economic value at the date of acceleration. Furthermore, following the authorization of our Shareholders meetings of March 2005, we have decided a new plan in the fourth quarter 2005 by granting non-vested stock awards to senior executives, selected employees and members of the Supervisory Board equivalent to approximately 4.1 million of shares. Part of our treasury shares was designated to be used for these new share-based remuneration programs. According to FAS 123R, we registered a total charge of $9 million in our income statement. The full impact on our financial position and results of operations is illustrated in the information presented in Note 15.6 to our Consolidated Financial Statements Non-vested share awards .

In 2005, we adopted Financial Accounting Standards Board Interpretation No. 47 *Accounting for Conditional Asset Retirement Obligations* (FIN 47). FIN 47 clarifies certain terms of Financial Accounting Standards Board No. 143 *Accounting for Asset Retirement Obligations* (FAS 143) and related FASB Staff Positions, and deals with obligations to perform asset retirement activities in which the timing and (or) method of settlement are conditional on a future event, such as legal requirements surrounding asbestos handling and disposal that are triggered by demolishing or renovating a facility. The new guidance requires entities to recognize liabilities for these obligations if the fair value of a conditional asset retirement obligation can be reasonably estimated. Upon adoption of FIN 47, we identified our conditional asset retirement obligations and determined that none had a material effect on our financial position or results of operations for the year ended December 31, 2005.

Impairment, Restructuring Charges and Other Related Closure Costs

In 2005, we have incurred charges related to the main following items: (i) the 150-mm restructuring plan started in 2003; (ii) the streamlining of certain activities decided in the first quarter 2005; (iii) the headcount reduction plan announced in second quarter of 2005; and (iv) the yearly impairment review.

During the third quarter of 2003, we commenced a plan to restructure our 150-mm fab operations and part of our back-end operations in order to improve cost competitiveness. The 150-mm restructuring plan focuses on cost reduction by migrating a large part of European and U.S. 150-mm production to Singapore and by upgrading production to a finer geometry 200-mm wafer fab. The plan includes the discontinuation of production of Rennes, France; the closure as soon as operationally feasible of the 150-mm wafer pilot line in

Castelletto, Italy; and the downsizing by approximately one-half of the 150-mm wafer fab in Carrollton, Texas. Furthermore, the 150-mm wafer fab productions in Agrate, Italy and Rousset, France will be gradually phased-out in favor of 200-mm wafer ramp-ups at existing facilities in these locations, which will be expanded or upgraded to accommodate additional finer geometry wafer capacity. This manufacturing restructuring plan designed to enhance our cost structure and competitiveness is moving ahead and we expect it to be completed in the second half of 2006 later than previously anticipated to accommodate unforeseen qualification requirements of our customers. The total plan of impairment and restructuring costs for the front-end and back-end reorganization is estimated to be approximately $350 million pre-tax of which $294 million has been incurred as of December 31, 2005 ($13 million in 2005, $76 million in 2004 and $205 million in 2003). The total actual costs that we will incur may differ from these estimates based on the timing required to complete the restructuring plan, the number of people involved, the final agreed termination benefits and the costs associated with the transfer of equipment, products and processes.

In the first quarter of 2005, we announced our decision to reduce Access technology products for CPE modem products in order to eliminate certain low volume, non-strategic product families whose returns in the current environment did not meet internal targets. This decision resulted in a total charge of $73 million for impairment of intangible assets and goodwill related to the CPE product lines and certain additional restructuring charges. This plan was completed in 2005.

In the second quarter of 2005, we announced a restructuring plan that, combined with other initiatives, that will aim to reduce our workforce by 3,000 outside Asia by the second half of 2006, of which 2,300 are planned for Europe. We will also pursue the upgrading of the 150-mm production fabs to 200-mm, we will optimize on a global scale our Electrical Wafer Sorting (EWS) activities and we will harmonize and streamline our support functions and disengage from certain activities. The total cost of these new measures has been estimated in the range of $100 to $130 million pre-tax at the completion of the plan, of which $41 million has been incurred as of December 31, 2005. The total actual costs that we will incur may differ from these estimates based on the timing required to complete the restructuring plan, the number of people involved, the final agreed termination benefits and the costs associated with the transfer of equipment, products and processes. This plan is expected to be completed in the second half of 2006.

In the third quarter of 2005, we performed the impairment test on an annual basis in order to assess the recoverability of the goodwill carrying value. As a result of this review, we have registered a $1 million charge in our 2005 accounts.

Impairment, restructuring charges and other related closure costs incurred in 2005 are summarized as follows:

	Year ended December 31, 2005			
	Impairment	**Restructuring charges**	**Other related closure costs**	**Total impairment, restructuring charges and other related closure costs**
	(in millions of U.S. dollars)			
150-mm fab plan		(4)	(9)	(13)
Restructuring initiatives decided in the first quarter 2005	(63)	(9)	(1)	(73)
Restructuring plan decided in the second quarter 2005.	(3)	(37)	(1)	(41)
Other	(1)			(1)
Total	**(67)**	**(50)**	**(11)**	**(128)**

In 2005, total cash outlays for the restructuring plan amounted to $56 million, corresponding mainly to the payment of expenses consisting of $33 million related to our 150-mm restructuring plan, $8 million related to our first quarter restructuring initiatives, $13 million related to our second quarter 2005 restructuring plan and $2 million related to other obligations accrued for in 2004.

See Note 18 to our Consolidated Financial Statements.

Equity Method Investments

SuperH, Inc.

In 2001, we formed with Renesas Technology Corp. (previously known as Hitachi, Ltd.) a joint venture to develop and license reduced instruction set computing (RISC) microprocessors. The joint venture, SuperH Inc., was initially capitalized with our contribution of $15 million of cash plus internally developed technologies with an agreed intrinsic value of $14 million for a 44% interest. Renesas Technology Corp. contributed $37 million of cash for a 56% interest. We accounted for our share in the SuperH, Inc. joint venture under the equity method based on the actual results of the joint venture. During 2002 and 2003, we made additional capital contributions on which accumulated losses exceeded our total investment, which was shown at zero carrying value in the consolidated balance sheet.

In 2003, the shareholders agreement was amended to require from us an additional $3 million cash contribution. This amount was fully accrued, based on the inability of the joint venture to meet its projected business plan objectives, and the charge was reflected in the 2003 consolidated statement of income line Impairment, restructuring charges and other related closure costs . In 2004, the shareholders agreed to restructure the joint venture by transferring the intellectual properties to each shareholder and continuing any further development individually. Based upon estimates of forecasted cash requirements of the joint venture, we paid an additional $2 million, which was reflected in the 2004 consolidated statement of income as Loss on equity investments . In 2005, the joint venture was liquidated with no further losses incurred.

UPEK Inc.

In 2004, we formed with Sofinnova Capital IV FCPR a new company, UPEK Inc., as a venture capital-funded purchase of our TouchChip business. UPEK Inc. was initially capitalized with our transfer of the business, personnel and technology assets related to the fingerprint biometrics business, formerly known as the TouchChip Business Unit, for a 48% interest. Sofinnova Capital IV FCPR contributed $11 million of cash for a 52% interest. During the first quarter of 2005, an additional $9 million was contributed by Sofinnova Capital IV FCPR, reducing our ownership to 33%. We accounted for our share in UPEK Inc. under the equity method and recorded in 2004 losses of approximately $2 million, which were reflected in the 2004 consolidated statement of income as Loss on equity investments .

On June 30, 2005, we sold our interest in UPEK Inc, for $13 million and recorded in the second quarter of 2005 a gain amounting to $6 million in Other Income and Expenses, net of our consolidated statement of income. Additionally, on June 30, 2005, we were granted warrants for 2,000,000 shares of UPEK Inc. at an exercise price of $0.01 per share. The warrants are not limited in time but can only be exercised in the event of a change of control or an Initial Public Offering of UPEK Inc. above a predetermined value.

Hynix ST Joint Venture

In 2004, we signed and announced the joint venture agreement with Hynix Semiconductor to build a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China. The joint venture is an extension of the NAND Flash Process/product joint development relationship. Construction of the facility began in 2005. When complete, the fab will employ approximately 1,500 people and will feature a 200-mm wafer production line planned to begin production at the end of 2006 and a 300-mm wafer production line planned to begin production in 2007. The total investment planned for the project is $2 billion. We will be contributing 33% of the equity financing, equivalent to $250 million, while Hynix will contribute 67%. We will also contribute $250 million as long-term debt to the new joint venture, guaranteed by subordinated collateral on the joint venture s assets. As of December 31, 2005, we have not provided any debt financing to the joint venture under this commitment. Our current maximum exposure to loss as a result of our involvement with the joint venture is limited to our equity and debt investment commitments. The financing will also include credit from local Chinese institutions, involving debt and a long leasehold. In 2005, our contributions to the equity investment reached approximately $38 million. We plan to subscribe the additional capital of $212 million in 2006 concurrently with Hynix and once the financing from local financing institutions is in place.

We have identified the joint venture as a Variable Interest Entity (VIE) at December 31, 2005, but have determined that we are not the primary beneficiary of the VIE. We are accounting for our share in the Hynix ST joint venture under the equity method based on the actual results of the joint venture and recorded losses of approximately $4 million as Loss on equity investments in our 2005 Consolidated Statement of Income.

Backlog and Customers

We entered 2006 with a backlog (including frame orders) that was significantly higher than we had entering 2005. This increase is due to high level of bookings and frames registered in the fourth quarter of 2005.

However, the level of frames included in our backlog are high and are subject to significant adjustments on the basis of future customer demand. In 2005, we had several large customers, with the Nokia Group of companies being the largest and accounting for approximately 22% of our revenues. Total original equipment manufacturers (OEMs) accounted for approximately 82% of our net revenues, of which the top ten OEM customers accounted for approximately 50%. Distributors accounted for approximately 18% of our net revenues. We have no assurance that the Nokia Group of companies, or any other customer, will continue to generate revenues for us at the same levels. If we were to lose one or more of our key customers, or if they were to significantly reduce their bookings, or fail to meet their payment obligations, our operating results and financial condition could be adversely affected.

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Changes to Our Share Capital, Stock Option Grants and Other Matters

The following table sets forth changes to our share capital as of December 31, 2005:

Year	Transaction	Number of shares	Nominal value (euro)	Cumulative amount of capital (euro)	Cumulative number of shares	Nominal value of increase/ reduction in capital	Amount of issue premium (euro)	Cumulative-issue premium (euro)
December 31, 2004	LYONs conversion	1,761	1.04	941,521,357	905,308,997	1,831	46,225	1,708,949,494
December 31, 2005	Conversion of bonds	59	1.04	941,521,418	905,309,056	61	1,448	1,708,950,942
December 31, 2005	Exercise of options	2,515,223	1.04	944,137,250	907,824,279	2,615,832	25,762,612	1,734,713,554

The following table summarizes the amount of stock options authorized to be granted, exercised, cancelled and outstanding as of December 31, 2005:

	Employees		Supervisory Board			
	1995 Plan	2001 Plan	1996	1999	2002	Total
Remaining amount authorized to be granted		12,265,817				12,265,817
Amount exercised	12,255,102	9,650	293,500	18,000		12,576,252
Amount cancelled	2,782,808	4,438,997	72,000	63,000	24,000	7,380,805
Amount outstanding	16,524,031	43,285,536	35,000	342,000	372,000	60,558,567

We granted 29,200 options at an exercise price of $16.73 on January 31, 2005 and 13,000 options at an exercise price of $17.31 on March 17, 2005.

In line with our 2005 AGM shareholders resolutions, we are transitioning our stock-based compensation plans from stock-option grants to non-vested stock awards. Pursuant to shareholders resolutions adopted by the 2005 AGM, our Supervisory Board, upon the recommendation of the Compensation Committee, approved the terms and conditions of the 2005 Supervisory Board Stock-Based Compensation Plan for members and professionals, which resulted in a $1 million charge in 2005.

Pursuant to shareholders resolutions adopted by the 2005 AGM, our Supervisory Board, upon the proposal of the Managing Board and the recommendation of the Compensation Committee, took the following actions:

amended our 2001 Employee Stock Option Plan with the aim of enhancing our ability to retain key employees and motivate them to shareholder value creation;

approved the vesting conditions, linked to our future performance and their continued service with us, to apply to non-vested stock awards granted to employees in 2005, the maximum number of which will be 4.1 million; and

accelerated the vesting of all of our outstanding stock options in July 2005 with no charge to our interim consolidated statements of income.

We intend to use 4.1 million of our shares held by us in treasury (out of the 13.4 million currently available) to cover the four million non-vested stock award granted to our employees in the fourth quarter of 2005 as well as the granting of up to 100,000 non-vested shares to the sole member of our Managing Board that was also approved by shareholders at the 2005 AGM.

Following these decisions, the share-based compensation plans generated a total additional charge in our income statement of the fourth quarter of 2005 of $9 million pre-tax. This charge corresponded to the compensation expense to be recognized for the non-vested stock awards from the grant date over the vesting period, by adopting FAS 123R and took into consideration the probability of the performance achievement by early adoption FAS123R. The vesting of the awards depends on the following performance achievement: (i) the total amount of shares will vest if the evolution of our stock price is equal or better to the evolution of the

Philadelphia SOX Index over the period from May 2, 2005 to April 1, 2006. If the awards do not vest pursuant to the market performance, the employees can still receive a maximum of 66% of the awards: (a) 33% if the evolution of our sales between May 2, 2005 and April 1, 2006 is equal to or greater than the evolution of the sales of top ten semiconductor companies publishing quarterly results for the quarter ending on or before April 1st, 2006 over the same corresponding quarter in 2005 and (b) 33% if our actual return on net assets achieved in 2005 is equal to or higher than our target as per 2005 budget. We will register a total charge of $31 million to which social charges should be added for a total cost of approximately $40 million (before tax) to be accounted for over the vesting period in the years 2006, 2007 and 2008.

Disclosure Controls and Procedures

Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(f)) as of the end of the period covered by this report, have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that material information relating to our company was made known to them by others within our company, particularly during the period in which this Form 6-K was being prepared.

There were no significant changes in our internal controls over financial reporting or in other factors that could significantly affect these controls during the period covered by the annual report, nor were there any material weaknesses in our internal controls requiring corrective actions.

Other Reviews

We have sent this report to our Audit Committee, which had an opportunity to raise questions with our management and independent auditors before we filed it with the Securities and Exchange Commission.

Cautionary Note Regarding Forward-Looking Statements

Some of the statements contained in this Form 6-K that are not historical facts, are statements of future expectations and other forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933 or Section 21E of the Securities Exchange Act of 1934, each as amended) that are based on management s current views and assumptions and are conditioned upon, and also involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those in such statements due to, among other factors:

- future developments of the world semiconductor market, in particular the future demand for semiconductor products in the key application markets and from key customers served by our products;

- pricing pressures, losses or curtailments of purchases from key customers;

- the financial impact of inadequate or excess inventories if actual demand differs from our anticipations;

- changes in the exchange rates between the U.S. dollar and the euro and between the U.S. dollar and the currencies of the other major countries in which we have our operating infrastructure;

- our ability to be successful in our strategic research and development initiatives to develop new products to meet anticipated market demand, as well as our ability to achieve our corporate performance roadmap by completing successfully and in a timely manner our other various announced initiatives to improve our overall efficiency and our financial performance;

- the anticipated benefits of research and development alliances and cooperative activities and the continued pursuit of our various alliances, in the field of development of new advanced technologies or products;

- the ability of our suppliers to meet our demands for products and to offer competitive pricing;

- changes in the economic, social or political environment, as well as natural events such as severe weather, health risks, epidemics or earthquakes in the countries in which we and our key customers operate;
- changes in our overall tax position as a result of changes in tax laws or the outcome of tax audits;
- product liability or warranty claims for a product containing one of our parts; and
- our ability to obtain required licenses on third-party intellectual property, the outcome of litigation and the results of actions by our competitors.

Such forward-looking statements are subject to various risks and uncertainties, which may cause actual results and performance of our business to differ materially and adversely from the forward-looking statements. Certain such forward-looking statements can be identified by the use of forward-looking terminology such as believes , expects , may , are expected to , will , will continue , should , would be , seeks or anticipates or similar expressions or the negative thereof or other variations thereof or comparable terminology, or by discussions of strategy, plans or intentions. Some of these risk factors are set forth and are discussed in more detail in Item 3. Key Information Risk Factors in our Form 20-F as may be updated from time to time. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this Form 6-K as anticipated, believed or expected. We do not intend, and do not assume any obligation, to update any industry information or forward-looking statements set forth in this Form 6-K to reflect subsequent events or circumstances. Unfavorable changes in the above or other factors listed under Item 3. Key Information Risk Factors from our Form 20-F, as may be updated from time to time, could have a material adverse effect on our business and/or financial condition.

STMICROELECTRONICS N.V.
AUDITED CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

To the Supervisory Board and Shareholders of
STMicroelectronics N.V.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in shareholders equity and of cash flows present fairly, in all material respects, the financial position of STMicroelectronics N.V. and its subsidiaries at December 31, 2005 and December 31, 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States).Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers SA

M Foley H-J Hofer

Geneva, February 15, 2006

PricewaterhouseCoopers is represented in about 140 countries worldwide and in Switzerland in Aarau, Basle, Berne, Chur, Geneva, Lausanne, Lucerne, Lugano, Neuchâtel, Sion, St. Gall, Thun, Winterthur, Zug and Zurich and offers Assurance, Tax & Legal and Advisory services.

STMicroelectronics N.V.
CONSOLIDATED STATEMENTS OF INCOME
In millions of U.S. dollars except per share amounts

	Twelve months ended		
	December 31, 2005	**December 31, 2004**	**December 31, 2003**
	(audited)	**(audited)**	**(audited)**
Net sales	8,876	8,756	7,234
Other revenues	6	4	4
Net revenues	**8,882**	**8,760**	**7,238**
Cost of sales	(5,845)	(5,532)	(4,672)
Gross profit	**3,037**	**3,228**	**2,566**
Selling, general and administrative	(1,026)	(947)	(785)
Research and development	(1,630)	(1,532)	(1,238)
Other income and expenses, net	(9)	10	(4)
Impairment, restructuring charges and other related closure costs	(128)	(76)	(205)
Operating income	**244**	**683**	**334**
Interest income (expense), net	34	(3)	(52)
Loss on equity investments	(3)	(4)	(1)
Loss on extinguishment of convertible debt	0	(4)	(39)
Income before income taxes and minority interests	**275**	**672**	**242**
Income tax benefit (expense)	(8)	(68)	14
Income before minority interests	**267**	**604**	**256**
Minority interests	(1)	(3)	(3)
Net income	**266**	**601**	**253**
Earnings per share (Basic)	0.30	0.67	0.29
Earnings per share (Diluted)	0.29	0.65	0.27

The accompanying notes are an integral part of these consolidated financial statements.

STMicroelectronics N.V.
CONSOLIDATED BALANCE SHEETS
In millions of U.S. dollars

	As at	
	December 31, 2005	**December 31, 2004**
	(audited)	**(audited)**
Assets		
Current assets:		
Cash and cash equivalents	2,027	1,950
Marketable securities	0	0
Trade accounts receivable, net	1,490	1,408
Inventories, net	1,411	1,344
Deferred tax assets	152	140
Other receivables and assets	531	785
Total current assets	**5,611**	**5,627**
Goodwill	221	264
Other intangible assets, net	224	291
Property, plant and equipment, net	6,175	7,442
Long-term deferred tax assets	55	59
Investments and other non-current assets	153	117
	6,828	**8,173**
Total assets	**12,439**	**13,800**
Liabilities and shareholders equity		
Current liabilities:		
Bank overdrafts	11	58
Current portion of long-term debt	1,522	133
Trade accounts payable	965	1,352
Other payables and accrued liabilities	642	776
Deferred tax liabilities	7	17
Accrued income tax	152	176
Total current liabilities	**3,299**	**2,512**
Long-term debt	269	1,767
Reserve for pension and termination indemnities	270	285
Long-term deferred tax liabilities	55	63
Other non-current liabilities	16	15
	610	**2,130**

Total liabilities	**3,909**	**4,642**
Commitment and contingencies		
Minority interests	**50**	**48**
Common stock (preferred stock: 540,000,000 shares authorized, not issued; common stock: Euro 1.04 nominal value, 1,200,000,000 shares authorized, 907,824,279 shares issued, 894,424,279 shares outstanding)	1,153	1,150
Capital surplus	1,967	1,924
Accumulated result	5,427	5,268
Accumulated other comprehensive income	281	1,116
Treasury stock	(348)	(348)
Shareholders equity	**8,480**	**9,110**
Total liabilities and shareholders equity	**12,439**	**13,800**

The accompanying notes are an integral part of these consolidated financial statements.

STMicroelectronics N.V.
CONSOLIDATED STATEMENTS OF CASH FLOWS
In millions of U.S. dollars

	Twelve Months Ended		
	December 31, 2005	**December 31, 2004**	**December 31, 2003**
	(audited)	**(audited)**	**(audited)**
Cash flows from operating activities:			
Net income	266	601	253
Items to reconcile net income and cash flows from operating activities:			
Depreciation and amortization	1,944	1,837	1,608
Amortization of discount on convertible debt	5	28	68
Loss on extinguishment of convertible debt		4	39
Gain on the sale of marketable securities			(4)
Other non-cash items	10	5	(53)
Minority interest in net income of subsidiaries	1	3	3
Deferred income tax	(31)	(6)	(131)
Loss on equity investments	3	4	1
Impairment, restructuring charges and other related closure costs, net of cash payments	72	8	197
Changes in assets and liabilities:			
Trade receivables, net	(117)	(119)	(109)
Inventories, net	(174)	(144)	(75)
Trade payables	(71)	128	(8)
Other assets and liabilities, net	(110)	(7)	131
Net cash from operating activities	**1,798**	**2,342**	**1,920**
Cash flows from investing activities:			
Payment for purchases of tangible assets	(1,441)	(2,050)	(1,221)
Proceeds from sale of marketable securities			4
Investment in intangible and financial assets	(49)	(79)	(31)
Capital contributions to equity investments	(38)	(2)	(3)
Payment for acquisitions, net of cash received		(3)	(188)
Net cash used in investing activities	**(1,528)**	**(2,134)**	**(1,439)**
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	50	91	1,398
Repayment of long-term debt	(110)	(1,288)	(1,432)
Increase (decrease) in short-term facilities	(47)	10	25
Capital increase	35	23	22
Dividends paid	(107)	(107)	(71)
Other financing activities	1		(1)

Net cash used in financing activities	**(178)**	**(1,271)**	**(59)**
Effect of changes in exchange rates	(15)	15	14
Net cash increase (decrease)	**77**	**(1,048)**	**436**
Cash and cash equivalents at beginning of the period	**1,950**	**2,998**	**2,562**
Cash and cash equivalents at end of the period	**2,027**	**1,950**	**2,998**
Supplemental cash information:			
Interest paid	17	16	19
Income tax paid	90	84	102

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY
In millions of U.S. dollars, except per share amounts

	Common Stock	Capital Surplus	Treasury Stock	Accumulated Result	Accumulated Other Comprehensive income (loss)	Shareholders Equity
Balance as of December 31, 2002 (audited)	**1,144**	**1,864**	**(348)**	**4,592**	**(258)**	**6,994**
Capital increase	**2**	**41**				**43**
Comprehensive income:						
Net Income				**253**		**253**
Other comprehensive income, net of tax					**881**	**881**
Comprehensive income						**1,134**
Dividends, $0.08 per share				(71)		(71)
Balance as of December 31, 2003 (audited)	**1,146**	**1,905**	**(348)**	**4,774**	**623**	**8,100**
Capital increase	**4**	**19**				**23**
Comprehensive income:						
Net Income				**601**		**601**
Other comprehensive income, net of tax					**493**	**493**
Comprehensive income						**1,094**
Dividends, $0.12 per share				(107)		(107)
Balance as of December 31, 2004 (audited)	**1,150**	**1,924**	**(348)**	**5,268**	**1,116**	**9,110**
Capital increase	**3**	**32**				**35**
Stock-based compensation expense		**11**				**11**
Comprehensive income (loss):						
Net income				**266**		**266**
Other comprehensive loss, net of tax					**(835)**	**(835)**
Comprehensive income (loss)						**(569)**

Dividends, $0.12 per share				(107)		(107)
Balance as of December 31, 2005 (audited)	**1,153**	**1,967**	**(348)**	**5,427**	**281**	**8,480**

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(in millions of U.S. dollars, except per share amounts)

1 THE COMPANY

STMicroelectronics N.V. (the Company) is registered in The Netherlands with its statutory domicile in Amsterdam. The Company was formed in 1987 with the original name of SGS-THOMSON Microelectronics by the combination of the semiconductor business of SGS Microelettronica (then owned by Società Finanziaria Telefonica (S.T.E.T.), an Italian corporation) and the non-military business of Thomson Semiconducteurs (then owned by Thomson-CSF, a French corporation) whereby each company contributed their respective semiconductor businesses in exchange for a 50% interest in the Company.

The Company is a global independent semiconductor company that designs, develops, manufactures and markets a broad range of semiconductor integrated circuits (ICs) and discrete devices. The Company offers a diversified product portfolio and develops products for a wide range of market applications, including automotive products, computer peripherals, telecommunications systems, consumer products, industrial automation and control systems. Within its diversified portfolio, the Company has focused on developing products that leverage its technological strengths in creating customized, system-level solutions with high-growth digital and mixed-signal content.

2 ACCOUNTING POLICIES

The accounting policies of the Company conform with accounting principles generally accepted in the United States of America (U.S. GAAP). All balances and values in the current and prior periods are in millions of dollars, except share and per-share amounts. Under Article 35 of the Company s Articles of Association, the financial year extends from January 1 to December 31, which is the period-end of each fiscal year.

2.1 Principles of consolidation

The consolidated financial statements of the Company have been prepared in conformity with U.S. GAAP. The Company s consolidated financial statements include the assets, liabilities, results of operations and cash flows of its majority-owned subsidiaries. The ownership of other interest holders is reflected as minority interests. Intercompany balances and transactions have been eliminated in consolidation. Since the adoption in 2003 of Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (revised 2003), and the related FASB Staff Positions (collectively FIN 46R), the Company assesses for consolidation any entity identified as a Variable Interest Entity (VIE) and consolidates VIEs, if any, for which the Company is determined to be the primary beneficiary, as described in note 2.19.

2.2 Use of estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. The primary areas that require significant estimates and judgments by management include, but are not limited to, sales returns and allowances, allowances for doubtful accounts, inventory reserves and normal manufacturing capacity thresholds to determine costs capitalized in inventory, accruals for warranty costs, litigation and claims, valuation of acquired intangibles, goodwill, investments and tangible assets as well as the impairment of their related carrying values, restructuring charges, assumptions used in calculating pension obligations and share-based compensation, assessment of hedge effectiveness of derivative instruments, deferred income tax assets including required valuation allowances and liabilities as well as provisions for specifically identified income tax exposures. The Company bases the estimates and assumptions on historical experience and on various other factors such as market trends and business plans that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. The actual results experienced by the Company could differ materially and adversely from management s estimates. To the extent there are material differences between the estimates and the actual results, future results of operations, cash flows and financial position could be significantly affected.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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2.3 Foreign currency

The U.S. dollar is the reporting currency for the Company, which is the currency of the primary economic environment in which the Company operates. The worldwide semiconductor industry uses the U.S. dollar as a currency of reference for actual pricing in the market. Furthermore, the majority of the Company s transactions are denominated in U.S. dollars, and revenues from external sales in U.S. dollars largely exceed revenues in any other currency. However, labor costs are concentrated primarily in the countries that have adopted the Euro currency.

The functional currency of each subsidiary throughout the group is generally the local currency. For consolidation purposes, assets and liabilities of these subsidiaries are translated at current rates of exchange at the balance sheet date. Income and expense items are translated at the monthly average exchange rate of the period. The effects of translating the financial position and results of operations from local functional currencies are reported as a component of accumulated other comprehensive income in the consolidated statements of changes in shareholders equity.

Assets, liabilities, revenues, expenses, gains or losses arising from foreign currency transactions are recorded in the functional currency of the recording entity at the exchange rate in effect during the month of the transaction. At each balance sheet date, recorded balances denominated in a currency other than the recording entity s functional currency are remeasured into the functional currency at the exchange rate prevailing at the balance sheet date. The related exchange gains and losses are recorded in the consolidated statements of income.

2.4 Derivative instruments

Foreign Currency Forward Contracts Not Designated as a Hedge

The Company conducts its business on a global basis in various major international currencies. As a result, the Company is exposed to adverse movements in foreign currency exchange rates. The Company enters into foreign currency forward contracts and currency options to reduce its exposure to changes in exchange rates and the associated risk arising from the denomination of certain assets and liabilities in foreign currencies at the Company s subsidiaries. These instruments do not qualify as hedging instruments under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), and are marked-to-market at each period-end with the associated changes in fair value recognized in other income and expenses, net in the consolidated statements of income.

Cash Flow Hedges

To further reduce its exposure to U.S. dollar exchange rate fluctuations, the Company also hedged in 2005 and 2004 certain euro-denominated forecasted transactions that cover at year-end a large part of its research and development, selling general and administrative expenses as well as a portion of its front-end manufacturing production costs of semi-finished goods. The foreign currency forward contracts used to hedge exposures are reflected at their fair value in the consolidated balance sheet and meet the criteria for designation as cash flow hedges. The criteria for designating a derivative as a hedge include the instrument s effectiveness in risk reduction and, in most cases, a one-to-one matching of the derivative instrument to its underlying transaction. Foreign currency forward contracts used as hedges are effective at reducing the euro/ U.S. dollar currency fluctuation risk and are designated as a hedge at the inception of the contract. For these derivatives, the gain or loss from the effective portion of the hedge is reported as a component of accumulated other comprehensive income in the consolidated statements of changes in shareholders equity and is reclassified into earnings in the same period in which the hedged transaction affects earnings, and within the same income statement line item as the impact of the hedged transaction. The gain or loss is recognized immediately in other income and expenses, net in the consolidated statements of income when a designated hedging instrument is either terminated early or an improbable or ineffective portion of the hedge is identified.

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2.5 Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

2.6 Revenue Recognition

Revenue is recognized as follows:

Net sales

Revenue from products sold to customers is recognized, pursuant to SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104), when all the following conditions have been met: (a) persuasive evidence of an arrangement exists; (b) delivery has occurred; (c) the selling price is fixed or determinable; and (d) collectibility is reasonably assured. This usually occurs at the time of shipment.

Consistent with standard business practice in the semiconductor industry, price protection is granted to distribution customers on their existing inventory of the Company s products to compensate them for declines in market prices. The ultimate decision to authorize a distributor refund remains fully within the control of the Company. The Company accrues a provision for price protection based on a rolling historical price trend computed on a monthly basis as a percentage of gross distributor sales. This historical price trend represents differences in recent months between the invoiced price and the final price to the distributor, adjusted if required, to accommodate a significant move in the current market price. The short outstanding inventory time period, visibility into the standard inventory product pricing (as opposed to certain customized products) and long distributor pricing history have enabled the Company to reliably estimate price protection provisions at period-end. The Company records the accrued amounts as a deduction of revenue at the time of the sale.

The Company s customers occasionally return the Company s products for technical reasons. The Company s standard terms and conditions of sale provide that if the Company determines that products are non-conforming, the Company will repair or replace the non-conforming products, or issue a credit or rebate of the purchase price. Quality returns are not related to any technological obsolescence issues and are identified shortly after sale in customer quality control testing. Quality returns are always associated with end-user customers, not with distribution channels. The Company provides for such returns when they are considered as probable and can be reasonably estimated. The Company records the accrued amounts as a reduction of revenue.

The Company s insurance policy relating to product liability only covers physical damage and other direct damages caused by defective products. The Company does not carry insurance against immaterial non consequential damages. The Company records a provision for warranty costs as a charge against cost of sales, based on historical trends of warranty costs incurred as a percentage of sales, which management has determined to be a reasonable estimate of the probable losses to be incurred for warranty claims in a period. Any potential warranty claims are subject to the Company s determination that the Company is at fault for damages, and such claims usually must be submitted within a short period following the date of sale. This warranty is given in lieu of all other warranties, conditions or terms express or implied by statute or common law. The Company s contractual terms and conditions limit its liability to the sales value of the products which gave rise to the claims.

Other revenues

Other revenues primarily consist of license revenue and patent royalty income, which are recognized ratably over the term of the agreements.

Fundings

Fundings received by the Company are mainly from governmental agencies and income is recorded as recognized when all contractually required conditions are fulfilled. The Company s primary sources for government funding are French, Italian, other European Union (EU) governmental entities and Singapore agencies. Such funding is generally provided to encourage research and development activities, industrialization and local economic development. The EU has developed model contracts for research and development funding that require beneficiaries to disclose the results to third parties on reasonable terms. The conditions for receipt of government funding may include eligibility restrictions, approval by EU authorities, annual budget appropriations, compliance with European Commission regulations, as well as specifications regarding objectives and results. Certain specific contracts contain

obligations to maintain a minimum level of employment and

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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investment during a certain period of time. There could be penalties if these objectives are not fulfilled. Other contracts contain penalties for late deliveries or for breach of contract, which may result in repayment obligations. In accordance with SAB 104 and the Company s revenue recognition policy, funding related to these contracts is recorded when the conditions required by the contracts are met. The Company s funding programs are classified under three general categories: funding for research and development activities, capital investment, and loans.

Funding for research and development activities is the most common form of funding that the Company receives. Public funding for research and development is recorded as other income and expenses, net in the Company s consolidated statements of income. Public funding for research and development is recognized ratably as the related costs are incurred once the agreement with the respective governmental agency has been signed and all applicable conditions are met.

Capital investment funding is recorded as a reduction of property, plant and equipment, net and is recognized in the Company s consolidated statements of income according to the depreciation charges of the funded assets during their useful lives. The Company also receives capital funding in Italy, which is recovered through the reduction of various governmental liabilities, including income taxes, value-added tax and employee-related social charges. The funding has been classified as long-term receivable and is reflected in the balance sheet at its discounted net present value. The subsequent accretion of the discount is recorded as non-operating income in interest income (expense), net .

The Company receives certain loans, mainly related to large capital investment projects, at preferential interest rates. The Company records these loans as debt in its consolidated balance sheet.

2.7 Advertising costs

Advertising costs are expensed as incurred and are recorded as selling, general and administrative expenses. Advertising expenses for 2005, 2004 and 2003 were $14 million, $17 million and $9 million, respectively.

2.8 Research and development

Research and development expenses include costs incurred by the Company, the Company s share of costs incurred by other research and development interest groups, and costs associated with co-development contracts. Research and development expenses do not include marketing design center costs, which are accounted for as selling expenses and process engineering, pre-production or process transfer costs which are recorded as cost of sales. Research and development costs are charged to expense as incurred. The amortization expense recognized on technologies and licenses purchased by the Company from third parties to facilitate the Company s research is recorded as research and development expenses.

2.9 Start-up costs

Start-up costs represent costs incurred in the start-up and testing of the Company s new manufacturing facilities, before reaching the earlier of a minimum level of production or 6-months after the fabrication line s quality qualification. Start-up costs are included in other income and expenses, net in the consolidated statements of income.

2.10 Income taxes

The provision for current taxes represents the income taxes expected to be paid or the benefit expected to be received related to the current year income or loss in each individual tax jurisdiction. Provisions for specific tax exposures are also estimated and recorded when an additional tax payment is determined probable. Deferred tax assets and liabilities are recorded for all temporary differences arising between the tax and book bases of assets and liabilities and for the benefits of tax credits and operating loss carry-forwards. Deferred income tax is determined using tax rates and laws that are enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled. The effect on deferred tax assets and liabilities from changes in tax law is recognized in the period of enactment. Deferred income tax assets are recognized in full but the Company assesses whether it is probable that future taxable profit will be available against which the temporary differences can be utilized. A valuation allowance is provided where

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necessary to reduce deferred tax assets to the amount for which management considers the possibility of recovery to be more likely than not. The Company utilizes the flow-through method to account for its investment credits, reflecting the credits as a reduction of tax expense in the year they are recognized. Similarly, research and development tax credits are classified as a reduction of tax expense in the year they are recognized.

2.11 Earnings per share

Basic earnings per share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed using the treasury stock method by dividing net income (adding-back interest expense, net of tax effects, related to convertible debt if determined to be dilutive) by the weighted average number of common shares and common share equivalents outstanding during the period. The weighted average shares used to compute diluted earnings per share include the incremental shares of common stock relating to stock-options granted, nonvested shares and convertible debt to the extent such incremental shares are dilutive. Nonvested shares with performance or market conditions are included in the computation of diluted earnings per share if their conditions have been satisfied at the balance sheet date and if the awards are dilutive.

2.12 Cash and cash equivalents

Cash and cash equivalents represents cash, deposits and highly liquid investments with insignificant interest rate risk purchased with an original maturity of ninety days or less.

2.13 Marketable securities

Management determines the appropriate classification of investments in debt and equity securities at the time of purchase and reassesses the classification at each reporting date. For those marketable securities with a readily determinable fair value and that are classified as available-for-sale, the securities are reported at fair value with changes in fair value recognized as a separate component of accumulated other comprehensive income (loss) in the consolidated statements of changes in shareholders equity. Other-than-temporary losses are recorded in net income based on the Company s assessment of any significant, sustained reductions in the investment s market value and of the market indicators affecting the securities. Gains and losses on securities sold are determined based on the specific identification method and are recorded as other income and expenses, net .

2.14 Trade accounts receivable

Trade accounts receivable are recognized at their sales value, net of allowances for doubtful accounts. The Company maintains an allowance for doubtful accounts for potential estimated losses resulting from its customers inability to make required payments. The Company bases its estimates on historical collection trends and records a provision accordingly. In addition, the Company is required to evaluate its customers financial condition periodically and records an additional provision for any specific account the Company estimates as doubtful.

2.15 Inventories

Inventories are stated at the lower of cost or net realizable value. Cost is based on the weighted average cost by adjusting standard cost to approximate actual manufacturing costs on a quarterly basis; the cost is therefore dependent on the Company s manufacturing performance. In the case of underutilization of manufacturing facilities, the costs associated with the excess capacity are not included in the valuation of inventories but charged directly to cost of sales. Net realizable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

Additionally, the Company evaluates its product inventory to identify obsolete or slow-selling stock and records a specific provision if the Company estimates the inventory will eventually become obsolete. Provisions for obsolescence are estimated for excess uncommitted inventory based on the previous quarter sales, orders backlog and production plans.

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2.16 Intangible assets subject to amortization

Intangible assets subject to amortization include the cost of technologies and licenses purchased from third parties, purchased software and internally developed software which is capitalized. Intangible assets subject to amortization are reflected net of any impairment losses. The carrying value of intangible assets subject to amortization is evaluated whenever changes in circumstances indicate that the carrying amount may not be recoverable. In determining recoverability, the Company usually estimates the fair value based on the projected discounted future cash flows associated with the intangible assets and compares this to their carrying value. An impairment loss is recognized in the income statement for the amount by which the asset s carrying amount exceeds its fair value. Amortization is computed using the straight-line method over the following estimated useful lives:

Technologies & licenses	3-7 years
Purchased software	3-4 years
Internally developed software	4 years

The Company evaluates the remaining useful life of an intangible asset at each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization.

The capitalization of costs for internally generated software developed by the Company for its internal use begins when preliminary project stage is completed and when the Company, implicitly or explicitly, authorizes and commits to funding a computer software project. It must be probable that the project will be completed and will be used to perform the function intended.

2.17 Goodwill

Goodwill recognized in business combinations is not amortized but rather is subject to an impairment test to be performed on an annual basis or more frequently if indicators of impairment exist, in order to assess the recoverability of its carrying value. Goodwill subject to potential impairment is tested at a reporting unit level, which represents a component of an operating segment for which discrete financial information is available and is subject to regular review by segment management. This impairment test determines whether the fair value of each reporting unit for which goodwill is allocated is lower than the total carrying amount of relevant net assets allocated to such reporting unit, including its allocated goodwill. If lower, the implied fair value of the reporting unit goodwill is then compared to the carrying value of the goodwill and an impairment charge is recognized for any excess. In determining the fair value of a reporting unit, the Company usually estimates the expected discounted future cash flows associated with the reporting unit. Significant management judgments and estimates are used in forecasting the future discounted cash flows, including: the applicable industry s sales volume forecast and selling price evolution, the reporting unit s market penetration, the market acceptance of certain new technologies, relevant cost structure, the discount rates applied using a weighted average cost of capital and the perpetuity rates used in calculating cash flow terminal values.

2.18 Property, plant and equipment

Property, plant and equipment are stated at historical cost, net of government fundings and any impairment losses. Major additions and improvements are capitalized, minor replacements and repairs are charged to current operations.

Land is not depreciated. Depreciation on fixed assets is computed using the straight-line method over the following estimated useful lives:

Buildings	33 years
Facilities & leasehold improvements	5-10 years
Machinery and equipment	3-6 years
Computer and R&D equipment	3-6 years
Other	2-5 years

The Company evaluates each period whether there is reason to suspect that tangible assets or groups of assets might not be recoverable. Several impairment indicators exist for making this assessment, such as: significant changes in the technological, market, economic or legal environment in which the Company operates or in the market to which the asset is dedicated, or available evidence of obsolescence of the asset, or indication

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that its economic performance is, or will be, worse than expected. In determining the recoverability of assets to be held and used, the Company initially assesses whether the carrying value of the tangible assets or group of assets exceeds the undiscounted cash flows associated with these assets. If exceeded, the Company then evaluates whether an impairment charge is required by determining if the asset s carrying value also exceeds its fair value. This fair value is normally estimated by the Company based on independent market appraisals or the sum of discounted future cash flows, using market assumptions such as the utilization of the Company s fabrication facilities and the ability to upgrade such facilities, change in the selling price and the adoption of new technologies. The Company also evaluates, and adjusts if appropriate, the assets useful lives, at each balance sheet date or when impairment indicators exist. Assets classified as held for disposal are reflected at the lower of their carrying amount or fair value less selling costs and are not depreciated during the selling period. Costs to sell include incremental direct costs to transact the sale that would not have been incurred except for the decision to sell.

When property, plant and equipment are retired or otherwise disposed of, the net book value of the assets is removed from the Company s books and the net gain or loss is included in other income and expenses, net in the consolidated statements of income.

Capital leases are included in property, plant and equipment, net and depreciated over the shorter of the estimated useful life or the lease term. Payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

Borrowing costs incurred for the construction of any qualifying asset are capitalized during the period of time that is required to complete and prepare the asset for its intended use. Other borrowing costs are expensed.

2.19 Investments

Equity investments are all entities over which the Company has the ability to exercise significant influence but not control, generally representing a shareholding of between 20% and 50% of the voting rights. These investments are accounted for by the equity method of accounting and are initially recognized at cost. The Company s share in its equity investments results is recognized in the consolidated income statement as Income (loss) on equity investments and in the consolidated balance sheet as an adjustment against the carrying amount of the investments. When the Company s share of losses in an equity investment equals or exceeds its interest in the investee, the Company does not recognize further losses, unless it has incurred obligations or made payments on behalf of the investee.

Investments without readily determinable fair values and for which the Company does not have the ability to exercise significant influence are accounted for under the cost method. Under the cost method of accounting, investments are carried at historical cost and are adjusted only for declines in fair value. For investments in public companies that have readily determinable fair values and for which the Company does not exercise significant influence, the Company classifies these investments as available-for-sale and, accordingly, recognizes changes in their fair values as a separate component of accumulated other comprehensive income (loss) in the consolidated statements of changes in shareholders equity. Other-than-temporary losses are recorded in net income and are based on the Company s assessment of any significant, sustained reductions in the investment s market value and of the market indicators affecting the securities. Gains and losses on investments sold are determined on the specific identification method and are recorded as other income or expenses, net in the consolidated statements of income.

Since the adoption in 2003 of Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (revised 2003), and the related FASB Staff Positions (collectively FIN 46R), the Company assesses for consolidation entities identified as a Variable Interest Entity (VIE) and consolidates the VIEs, if any, for which the Company is determined to be the primary beneficiary. The primary beneficiary of a VIE is the party that absorbs the majority of the entity s expected losses, receives the majority of its expected residual returns, or both as a result of holding variable interests. Assets, liabilities, and the non-controlling interest of newly consolidated VIEs are initially measured at fair value in the same manner as if the consolidation resulted from a business combination.

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2.20 Employee benefits

(a) Pension obligations

The Company sponsors various pension schemes for its employees. These schemes conform to local regulations and practices in the countries in which the Company operates. They are generally funded through payments to insurance companies or trustee-administered funds, determined by periodic actuarial calculations. Such plans include both defined benefit and defined contribution plans. A defined benefit plan is a pension plan that defines the amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation. A defined contribution plan is a pension plan under which the Company pays fixed contributions into a separate entity. The Company has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods.

The liability recognized in the consolidated balance sheets in respect of defined benefit pension plans is the present value of the defined benefit obligation at the balance sheet date less the fair value of plan assets, together with adjustments for unrecognized actuarial gains and losses and past service costs. Significant estimates are used in determining the assumptions incorporated in the calculation of the pension obligations, which is supported by input from independent actuaries. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to income over the employees expected average remaining working lives. Past-service costs are recognized immediately in income, unless the changes to the pension scheme are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past-service costs are amortized on a straight-line basis over the vesting period. Additional minimum liability is required when the accumulated benefit obligation exceeds the fair value of the plan assets and the amount of the accrued liability. Such minimum liability is recognized as a component of accumulated other comprehensive income (loss) in the consolidated statements of changes in shareholders equity. The net periodic benefit cost of the year is determined based on the assumptions used at the end of the previous year.

For defined contribution plans, the Company pays contributions to publicly or privately administered pension insurance plans on a mandatory, contractual or voluntary basis. The Company has no further payment obligations once the contributions have been paid. The contributions are recognized as employee benefit expense when they are due. Prepaid contributions are recognized as an asset to the extent that a cash refund or a reduction in the future payments is available.

(b) Other post-employment obligations

The Company provides post-retirement benefits to some of its retirees. The entitlement to these benefits is usually conditional on the employee remaining in service up to retirement age and to the completion of a minimum service period. The expected costs of these benefits are accrued over the period of employment using an accounting methodology similar to that for defined benefit pension plans. Actuarial gains and losses arising from experience adjustments, and changes in actuarial assumptions, are charged or credited to income over the expected average remaining working lives of the related employees. These obligations are valued annually by independent qualified actuaries.

(c) Termination benefits

Termination benefits are payable when employment is involuntarily terminated, or whenever an employee accepts voluntary termination in exchange for these benefits. For the accounting treatment and timing recognition of the involuntarily termination benefits, the Company distinguishes between one-time benefit arrangements and ongoing termination arrangements. A one-time benefit arrangement is one that is established by a termination plan that applies to a specified termination event or for a specified future period. These one-time involuntary termination benefits are recognized as a liability when the termination plan meets certain criteria and has been communicated to employees. If employees are required to render future service in order to receive these one-time termination benefits, the liability is recognized ratably over the future service period. Termination benefits other than one-time termination benefits are termination benefits for which criteria for communication are not met but that are committed to by management, or

termination obligations that are not specifically determined in a new and single plan. These termination benefits are all legal, contractual and past practice termination obligations to be paid to employees in case of involuntary termination. These termination benefits are accrued for at

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commitment date when it is probable that employees will be entitled to the benefits and the amount can be reasonably estimated.

In the case of special termination benefits proposed to encourage voluntary termination, the Company recognizes a provision for voluntary termination benefits at the date on which the employee irrevocably accepts the offer and the amount can be reasonably estimated.

(d) Profit-sharing and bonus plans

The Company recognizes a liability and an expense for bonuses and profit-sharing plans when it is contractually obliged or where there is a past practice that has created a constructive obligation.

(e) Share-based compensation

Stock options

At December 31, 2005, the Company had five employee and Supervisory Board stock-option plans, which are described in detail in Note 15. Until the fourth quarter of 2005, the Company applied the intrinsic-value-based method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and its related implementation guidance, in accounting for stock-based awards to employees. For all option grants prior to the fourth quarter of 2005, no stock-based employee compensation cost was reflected in net income as all options under those plans were granted at an exercise price equal to the market value of the underlying common stock on the date of grant.

The following tabular presentation provides pro forma information on net income and earnings per share required to be disclosed as if the Company had applied the fair value recognition provisions prescribed by Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (FAS 123), for the years ended December 31, 2005, 2004 and 2003:

	Year ended December 31, 2005	**Year ended December 31, 2004**	**Year ended December 31, 2003**
Net income, as reported	**266**	601	253
of which compensation expense on nonvested shares, net of tax effect	*(7)*		
Deduct: Total stock-option employee compensation expense determined under FAS 123, net of related tax effects	**(244)**	(166)	(186)
Net income, pro forma	**22**	435	67
Earnings per share:			
Basic, as reported	**0.30**	0.67	0.29
Basic, pro forma	**0.02**	0.49	0.08
Diluted, as reported	**0.29**	0.65	0.27
Diluted, pro forma	**0.02**	0.47	0.07

The Company has amortized the pro forma compensation expense over the nominal vesting period for employees. The pro forma information presented above for the year ended December 31, 2005 includes an approximate $182 million charge relating to the effect of accelerating the vesting period of all outstanding unvested stock options during the third quarter of 2005, which has been recognized immediately in the pro forma result for the amount that otherwise would have been recognized ratably over the remaining vesting period.

The fair value of the Company s stock options was estimated under FAS 123 using a Black-Scholes option pricing model since the simple characteristics of the stock options did not require complex pricing assumptions. Forfeitures of

options are reflected in the pro forma charge as they occur. For those stock option plans with graded vesting periods, the Company has determined that the historical exercise activity actually reflects that employees exercise the option after the close of the graded vesting period. Therefore, the Company recognizes the estimated pro forma charge for stock option plans with graded vesting period on a straight-line basis.

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The fair value of stock options under FAS 123 provisions was estimated using the following weighted-average assumptions:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Expected life (years)	**6.1**	6.1	5.9
Historical Company share price volatility	**52.9%**	56.4%	59.6%
Risk-free interest rate	**3.84%**	3.6%	2.7%
Dividend yield	**0.69%**	0.56%	0.35%

The Company has determined the historical share price volatility to be the most appropriate estimate of future price activity. The weighted average fair value of stock options granted during 2005 was $8.60 ($12.14 in 2004 and $10.66 in 2003).

Nonvested shares

In 2005, the Company redefined its equity-based compensation strategy by no longer granting options but rather issuing nonvested shares. In July 2005, the Company amended its latest Stock Option Plans for employees, Supervisory Board and Professionals of the Supervisory Board accordingly. As part of this revised stock-based compensation policy, the Company decided in July 2005 to accelerate the vesting period of all outstanding unvested stock options, following authorization from the Company s shareholders at the annual general meeting held on March 18, 2005. As a result, underwater options equivalent to approximately 32 million shares became exercisable immediately in July 2005 with no earnings impact. In addition, on October 25, 2005, the Company granted nonvested shares to senior executives, selected employees and members of the Supervisory Board to be issued upon vesting from treasury stock. The shares were granted for free to employees and at their nominal value for the members of the Supervisory Board. The awards granted to employees will contingently vest upon achieving certain market or performance conditions and upon completion of a three-year service period.

Shares granted to the Supervisory Board vest unconditionally along the same vesting period as employees. Since nonvested shares granted to Supervisory Board members are not forfeited, even if the service period is not completed, their associated compensation cost has been recorded immediately at grant. Nonvested share grants are further explained in Note 15.

In the fourth quarter of 2005 the Company decided to early adopt Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, and the related FASB Staff Positions (collectively FAS 123R), which requires a public entity to measure the cost of share-based service awards based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period, usually the vesting period. The early adoption of FAS 123R is described in Note 2.24.

2.21 Convertible debt

Zero-coupon convertible bonds are recorded at the principal amount on maturity in long-term debt and are presented net of the debt discount on issuance. This discount is amortized over the term of the debt as interest expense using the interest rate method.

Zero-coupon convertible bonds issued with a negative yield are initially recorded at their accreted value as of the first redemption right of the holder. The negative yield is recorded as capital surplus and represents the difference between the principal amount at issuance and the lower accreted value at the first redemption right of the holder.

Debt issuance costs are included in long-term investments and are amortized in interest income (expense), net until the first redemption right of the holder. Outstanding bonds amounts are classified in the consolidated balance sheet as current portion of long term debt in the year of the redemption right of the holder.

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2.22 Share capital

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

Where any subsidiary purchases the Company s equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs (net of income taxes), is deducted from equity attributable to the Company s equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received net of directly attributable incremental transaction costs and the related income tax effect is included in equity.

2.23 Comprehensive income (loss)

Comprehensive income (loss) is defined as the change in equity of a business during a period except those resulting from investment by shareholders and distributions to shareholders. In the accompanying consolidated financial statements, accumulated other comprehensive income (loss) consists of, unrealized gains or losses on marketable securities classified as available-for-sale, the change in the excess of the minimum pension liability over the unrecognized prior service cost of certain pension plans and the unrealized gain (loss) on derivatives, all net of tax as well as foreign currency translation adjustments.

2.24 Recent accounting pronouncements

In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* (FAS 151). The Standard requires abnormal amounts of idle capacity and spoilage costs to be excluded from the cost of inventory and expensed when incurred. The provisions of FAS 151 are applicable prospectively to inventory costs incurred during fiscal years beginning after June 15, 2005. The Company early adopted FAS 151 in 2005. As costs associated with underutilization of manufacturing facilities have historically been charged directly to cost of sales, FAS 151 has not had a material effect on the Company s financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (FAS 153). This Statement amends Opinion 29 to eliminate the exception to the basic fair value measurement principle for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of transactions that do not have commercial substance, that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. The Statement is effective prospectively for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005, with early application permitted. The Company early adopted FAS 153 in 2005 but has not had any material nonmonetary exchanges of assets since FAS 153 was published. Therefore, FAS 153 has not had a material effect on the Company s financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, and the related FASB Staff Positions (collectively FAS 123R). This Statement revises FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. FAS 123R requires a public entity to measure the cost of share-based service awards based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period, usually the vesting period. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. FAS 123R also requires more extensive disclosures than the previous standards relating to the nature of share-based payment transactions, compensation cost and cash flow effects. On April 14, 2005, the U.S. Securities and Exchange Commission amended the effective date of FAS 123R; the Statement now applies to all awards granted and to all unvested awards modified, repurchased, or cancelled during the first annual reporting period beginning after June 15, 2005. FAS 123R provides a choice of transition methods including the modified prospective application method, which allows discretionary restatement of interim periods during the

calendar year of adoption, or the modified retrospective application method, which allows the restatement of the prior years presented. Each method requires the cumulative effect of initially applying FAS 123R to be recognized in the period of adoption. The Company early adopted FAS 123R in the fourth quarter of 2005 using the modified prospective application

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method. As such, the Company has not restated prior periods to reflect the recognition of stock-based compensation cost. The Company redefined in the second quarter of 2005 its equity-based compensation strategy, since it had become minimally effective in motivating and retaining key-employees. The Company will no longer grant options but rather issue nonvested shares. As part of this revised equity-based compensation policy, the Company decided in July 2005 to accelerate the vesting period of all outstanding unvested stock options. These options totaling approximately 32 million had no intrinsic economic value based on the market price of the shares at the date of acceleration. The acceleration of the vesting period will avoid any future compensation expense associated with FAS 123R; accordingly, the Company did not recognize any cumulative effect of initially adopting FAS 123R since no outstanding unvested stock awards existed as of the adoption date of FAS 123R. The impact of FAS 123R on the Company s grant of nonvested shares in the fourth quarter of 2005 is further illustrated in Note 15.

In 2005, the Company adopted Financial Accounting Standards Board Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47). FIN 47 clarifies certain terms of Financial Accounting Standards Board No. 143, *Accounting for Asset Retirement Obligations* (FAS 143), and related FASB Staff Positions, and deals with obligations to perform asset retirement activities in which the timing and (or) method of settlement are conditional on a future event, such as legal requirements surrounding asbestos handling and disposal that are triggered by demolishing or renovating a facility. The new guidance requires entities to recognize liabilities for these obligations if the fair value of a conditional asset retirement obligation can be reasonably estimated. Upon adoption of FIN 47, the Company identified its conditional asset retirement obligations and determined that none had a material effect on its financial position or results of operations for the year ended December 31, 2005.

3 EQUITY-METHOD INVESTMENTS

SuperH Joint Venture

In 2001, the Company and Renesas Technology Corp. (previously known as Hitachi, Ltd.) formed a joint venture to develop and license RISC microprocessors. The joint venture, SuperH Inc., was initially capitalized with the Company s contribution of $15 million of cash plus internally developed technologies with an agreed intrinsic value of $14 million for a 44% interest. Renesas Technology Corp. contributed $37 million of cash for a 56% interest. The Company accounted for its share in the SuperH, Inc. joint venture under the equity method based on the actual results of the joint venture. During 2002 and 2003, the Company made additional capital contributions on which accumulated losses exceeded the Company s total investment, which was shown at a zero carrying value in the consolidated balance sheet.

In 2003, the shareholders agreement was amended to require an additional $3 million cash contribution from the Company. This amount was fully accrued, based on the inability of the joint venture to meet its projected business plan objectives, and the charge was reflected in the 2003 consolidated statement of income line Impairment, restructuring charges and other related closure costs . In 2004, the shareholders agreed to restructure the joint venture by transferring the intellectual properties to each shareholder and continuing any further development individually. Based upon estimates of forecasted cash requirements of the joint venture, the Company paid an additional $2 million, which was reflected in the 2004 consolidated statement of income as loss on equity investments . In 2005, the joint venture was liquidated with no further losses incurred by the Company.

UPEK Inc.

In 2004, the Company and Sofinnova Capital IV FCPR formed a new company, UPEK Inc., as a venture capitalist-funded purchase of the Company s TouchChip business. UPEK, Inc. was initially capitalized with the Company s transfer of the business, personnel and technology assets related to the fingerprint biometrics business, formerly known as the TouchChip Business Unit, for a 48% interest. Sofinnova Capital IV FCPR contributed $11 million of cash for a 52% interest. During the first quarter of 2005, an additional $9 million was contributed by Sofinnova Capital IV FCPR, reducing the Company s ownership to 33%. The Company accounted for its share in UPEK, Inc. under the equity method and in 2004 recorded losses of approximately $2 million, which were reflected in the 2004 consolidated statement of income as Loss on equity investments .

On June 30, 2005, the Company sold its interest in UPEK Inc. for $13 million and recorded a gain amounting to $6 million in Other income and expenses, net on its consolidated statement of income.

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Additionally, on June 30, 2005, the Company was granted warrants for 2,000,000 shares of UPEK, Inc. at an exercise price of $0.01 per share. The warrants are not limited in time but can only be exercised in the event of a change of control or an Initial Public Offering of UPEK Inc. above a predetermined value.

Hynix ST Joint Venture

Pursuant to the joint-venture agreement signed in 2004 by the Company with Hynix Semiconductor Inc. to build a $2 billion front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China, the Company made capital contributions to the joint venture totaling $38 million in 2005. Under the agreement, Hynix Semiconductor Inc. will contribute $500 million for a 67% equity interest and the Company will contribute $250 million for a 33% equity interest. In addition, the Company committed to grant $250 million in long-term financing to the new joint venture guaranteed by the subordinated collateral of the joint-venture s assets. As of December 31, 2005 the Company has not provided any debt financing to the joint venture under this commitment. The Company s current maximum exposure to loss as a result of its involvement with the joint venture is limited to its equity and debt investment commitments.

The Company has identified the joint venture as a Variable Interest Entity (VIE) at December 31, 2005, but has determined that it is not the primary beneficiary of the VIE. The Company accounts for its share in the Hynix ST joint venture under the equity method based on the actual results of the joint venture and recorded losses totaling $4 million in 2005 as loss on equity investments .

4 TRADE ACCOUNTS RECEIVABLE, NET

Trade accounts receivable, net consisted of the following:

	December 31, 2005	December 31, 2004
Trade accounts receivable	**1,517**	1,429
Less valuation allowance	**(27)**	(21)
Total	**1,490**	1,408

Bad debt expense in 2005 and 2004 was $7 and $5 million, respectively. In 2003, the Company decreased its valuation allowance and recorded income of $10 million. In 2005, 2004 and 2003, one customer, the Nokia group of companies, represented 22.4%, 17.1% and 17.9% of consolidated net revenues, respectively.

5 INVENTORIES, NET

Inventories, net of reserve consisted of the following:

	December 31, 2005	December 31, 2004
Raw materials	**60**	70
Work-in-process	**880**	874
Finished products	**471**	400
Total	**1,411**	1,344

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6 OTHER RECEIVABLES AND ASSETS

Other receivables and assets consisted of the following:

	December 31, 2005	December 31, 2004
Receivables from government agencies	**168**	212
Taxes and other government receivables	**189**	143
Advances to suppliers	**2**	3
Advances to employees	**10**	16
Prepaid expenses	**48**	88
Sundry debtors within cooperation agreements	**67**	85
Foreign exchange forward contracts	**3**	200
Other	**44**	38
Total	**531**	785

Receivables from government agencies relate to research and development contracts, industrialization contracts and capital investment projects.

7 GOODWILL

Changes in the carrying amount of goodwill were as follows:

	Application Specific Products	Memory Products	Other	Total
December 31, 2003	**176**	85	6	267
TouchChip sale			(3)	(3)
Foreign currency translation	(3)	3		
December 31, 2004	173	88	3	264
CPE goodwill impairment	**(39)**			(39)
Foreign currency translation		(3)	(1)	(4)
December 31, 2005	**134**	**85**	**2**	**221**

In 2005, the Company decided to reduce its Access technology products for Customer Premises Equipment (CPE) modem products. The Company reports CPE business as part of the Access reporting unit, included in the Application Specific Product Groups (ASG). Following the decision to discontinue a portion of this reporting unit, the Company, in compliance with FAS 142, *Goodwill and Other Intangible Assets*, reassessed the allocation of goodwill between the continuing Access reporting unit and the business to be disposed of according to their relative fair values using market comparables. The reassessment resulted in a $39 million goodwill impairment in 2005.

8 INTANGIBLE ASSETS

Intangible assets consisted of the following:

December 31, 2005	Gross Cost	Accumulated Amortization	Net Cost
Technologies & licenses	**309**	**(199)**	**110**
Purchased software	**162**	**(114)**	**48**
Internally developed software	**114**	**(48)**	**66**
Total	**585**	**(361)**	**224**

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December 31, 2004	Gross Cost	Accumulated Amortization	Net Cost
Technologies & licenses	409	(233)	176
Purchased software	148	(100)	48
Internally developed software	104	(37)	67
Total	661	(370)	291

The aggregate amortization expense in 2005, 2004 and 2003 was $98 million, $112 million and $103 million, respectively.

The estimated amortization expense of the existing intangible assets for the following years is:

Year	
2006	**107**
2007	**68**
2008	**33**
2009	**11**
2010	**4**
Thereafter	**1**
Total	**224**

9 PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consisted of the following:

December 31, 2005	Gross Cost	Accumulated Depreciation	Net Cost
Land	**84**		**84**
Buildings	**1,071**	**(267)**	**804**
Capital leases	**55**	**(29)**	**26**
Facilities & leasehold improvements	**2,715**	**(1,294)**	**1,421**
Machinery and equipment	**12,473**	**(9,063)**	**3,410**
Computer and R&D equipment	**492**	**(381)**	**111**
Other tangible assets	**131**	**(103)**	**28**
Construction in progress	**291**		**291**
Total	**17,312**	**(11,137)**	**6,175**

	Gross	Accumulated	Net

December 31, 2004	Cost	Depreciation	Cost
Land	93		93
Buildings	1,021	(250)	771
Capital leases	66	(31)	35
Facilities & leasehold improvements	2,763	(1,187)	1,576
Machinery and equipment	12,898	(8,581)	4,317
Computer and R&D equipment	516	(382)	134
Other tangible assets	125	(108)	17
Construction in progress	499		499
Total	17,981	(10,539)	7,442

The depreciation charge in 2005, 2004 and 2003 was $1,846 million, $1,725 million and $1,505 million, respectively.

Capital investment funding has totaled $38 million, $46 million and $62 million in the years ended December 31, 2005, 2004 and 2003, respectively. Public funding reduced the depreciation charge by $66 million, $74 million and $80 million in 2005, 2004 and 2003, respectively.

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For the years ended December 31, 2005, 2004 and 2003 the Company made equipment sales for cash proceeds of $82 million, $10 million and $8 million, respectively.

10 AVAILABLE-FOR-SALE MARKETABLE SECURITIES

In 2003 the Company has classified certain marketable securities as available-for-sale, which related to equity securities held as strategic investments in various companies. During 2004, all available-for-sale securities were sold. For fiscal years 2005, 2004 and 2003, gross realized gains associated with the sale of the marketable securities were $0 million, $5 million and $16 million, respectively.

11 INVESTMENTS AND OTHER NON-CURRENT ASSETS

Investments and other non-current assets consisted of the following:

	December 31, 2005	December 31, 2004
Equity-method investments (see note 3)	**35**	6
Cost investments	**36**	34
Long-term receivables related to funding	**33**	33
Debt issuance costs, net	**3**	8
Deposits and other long-term receivables	**46**	36
Total	**153**	117

The Company entered into a joint venture agreement in 2002 with Dai Nippon Printing Co, Ltd for the development and production of photomask in which the Company holds a 19% equity interest. The joint venture, DNP Photomask Europe S.p.A, was initially capitalized with the Company s contribution of 2 million of cash. Dai Nippon Printing Co, Ltd contributed 8 million of cash for an 81% equity interest. In the event of the liquidation of the joint-venture, the Company is required to repurchase the land at cost, and the facility at 10% of its net book value, if no suitable buyer is identified. No provision for this obligation has been registered to date. At December 31, 2005, the Company s total contribution to the joint venture is $10 million. The Company continues to maintain its 19% ownership of the joint venture, and therefore continues to account for this investment under the cost method.

The Company has identified the joint venture as a Variable Interest Entity (VIE), but has determined that it is not the primary beneficiary of the VIE.

12 OTHER PAYABLES AND ACCRUED LIABILITIES

Other payables and accrued liabilities consisted of the following:

	December 31, 2005	December 31, 2004
Taxes other than income taxes	**77**	68
Salaries and wages	**248**	261
Social charges	**110**	120
Advances received on government fundings	**24**	25
Foreign exchange forward contracts	**31**	109
Current portion of provision for restructuring	**40**	39
Pension and termination benefits	**21**	11
Other	**91**	143

Total	**642**	776

Other payables and accrued liabilities also include individually insignificant amounts as of December 31, 2005 and December 31, 2004.

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13 RETIREMENT PLANS

The Company and its subsidiaries have a number of defined benefit pension plans covering employees in various countries. The plans provide for pension benefits, the amounts of which are calculated based on factors such as years of service and employee compensation levels. The Company uses a December 31 measurement date for the majority of its plans. Eligibility is generally determined in accordance with local statutory requirements.

The changes in benefit obligation and plan assets were as follows:

	December 31, 2005	December 31, 2004
Change in benefit obligation:		
Benefit obligation at beginning of year	**286**	249
Service cost	**18**	18
Interest cost	**14**	13
Benefits paid	**(10)**	(6)
Actuarial losses	**34**	
Foreign currency translation adjustments	**(24)**	15
Other	**5**	(3)
Benefit obligation at end of year	**323**	286
Change in plan assets:		
Plan assets at fair value at beginning of year	**181**	150
Actual return on plan assets	**11**	11
Employer and participant contributions	**16**	19
Benefits paid	**(10)**	(6)
Actuarial gain (losses)	**10**	(2)
Foreign currency translation adjustments	**(14)**	9
Plan assets at fair value at end of year	**194**	181
Funded status	**(129)**	(105)
Unrecognized prior service cost	**(3)**	(3)
Unrecognized transition obligation	**(1)**	(1)
Unrecognized actuarial loss	**77**	60
Net amount recognized	**(56)**	(49)
Net amount recognized in the balance sheet consisted of the following:		
Prepaid benefit cost	**2**	2
Accrued benefit liability	**(93)**	(93)
Intangible asset	**1**	1
Accumulated other comprehensive income	**34**	41
Net amount recognized	**(56)**	(49)

The projected benefit obligation, accumulated benefit obligation, and fair value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets were $313 million, $270 million and $184 million, respectively, as of December 31, 2005 and $251 million, $216 million and $147 million, respectively, as of December 31, 2004.

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The components of the net periodic benefit cost included the following:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Service cost	**18**	18	14
Interest cost	**14**	13	10
Expected return on plan assets	**(11)**	(11)	(7)
Amortization of unrecognized transition obligation			
Amortization of net loss	**3**	8	2
Amortization of prior service cost		1	1
Net periodic benefit cost	**24**	29	20

The weighted average assumptions used in the determination of the benefit obligation for the pension plans were as follows:

Assumptions	December 31, 2005	December 31, 2004	December 31, 2003
Discount rate	**4.54%**	5.02%	5.25%
Salary increase rate	**3.75%**	3.34%	3.34%
Expected long-term rate of return on funds for the pension expense of the year	**6.34%**	6.44%	6.75%

The discount rate was determined by comparison against long-term corporate bond rates applicable to the respective country of each plan. In developing the expected long-term rate of return on assets, the Company modelled the expected long-term rates of return for broad categories of investments held by the plan against a number of various potential economic scenarios.

The Company pension plan asset allocation at December 31, 2005 and 2004 and target allocation for 2005 are as follows:

Asset Category	Target allocation 2005	Percentage of Plan Assets at December 2005	2004
Equity securities	57%	61%	57%
Fixed income securities	39%	37%	39%
Real estate	2%	2%	2%
Other	2%		2%
Total	100%	100%	100%

The Company s investment strategy for its pension plans is to maximize the long-term rate of return on plan assets with an acceptable level of risk in order to minimize the cost of providing pension benefits while maintaining adequate funding levels. The Company s practice is to periodically conduct a strategic review of its asset allocation strategy. A portion of the fixed income allocation is reserved in short-term cash to provide for expected benefits to be paid. The Company s equity portfolios are managed in such a way as to achieve optimal diversity. The Company does not manage any assets internally and does not utilize hedging, future or derivative instruments.

After considering the funded status of the Company s defined benefit plans, movements in the discount rate, investment performance and related tax consequences, the Company may choose to make contributions to its pension plans in any given year in excess of required amounts. The Company contributions to plan assets were $12 million and $17 million in 2005 and 2004, respectively. The Company expects to contribute cash of $8 million in 2006.

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The Company s estimated future benefit payments as of December 2005 are as follows:

Years	Estimated future benefit payments
2006	9
2007	8
2008	10
2009	10
2010	7
From 2011 to 2015	66

The Company also has other plans not calculated based on the employees expected date of separation or retirement:

For Italian termination indemnity plan (TFR), the Company calculates the vested benefits to which Italian employees are entitled if they separate immediately as of December 2005, in compliance with the Emerging Issues Task Force Issue No. 88-1, *Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan* (EITF 88-1). The benefits accrued on a pro-rata basis during the employees employment period are based on the individuals salaries, adjusted for inflation. Movements in the reserve were as follows:

Balance as of December 31, 2002	129
Provision for the year	29
Indemnities paid during the year	(19)
Foreign currency translation adjustments	31
Balance as of December 31, 2003	170
Provision for the year	33
Indemnities paid during the year	(25)
Foreign currency translation adjustments	14
Balance as of December 31, 2004	192
Provision for the year	34
Indemnities paid during the year	(18)
Foreign currency translation adjustments	(26)
Balance as of December 31, 2005	182

The Company has certain defined contribution plans, which accrued benefits for employees on a pro-rata basis during their employment period based on their individual salaries. The Company accrued benefits related to defined contribution pension plans of $21 million and $11 million, as of December 31, 2005 and 2004, respectively. The annual cost of these plans amounted to approximately $42 million, $29 million and $25 million in 2005, 2004 and 2003, respectively. The benefits accrued to the employees on a pro-rata basis, during their employment period are based on the individuals salaries.

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14 LONG-TERM DEBT

Long-term debt consisted of the following:

	December 31, 2005	December 31, 2004
Bank loans:		
2.62% (weighted average), due 2006, floating interest rate at Libor + 0.30	**45**	105
2.53% (weighted average), due 2007, fixed interest rate	**120**	153
4.77% (weighted average rate), due 2007, variable interest rate	**36**	44
5.08% due 2008, floating interest rate at Libor + 0.40	**25**	
5.11% due 2010, floating interest rate at Libor + 0.40	**25**	
Funding program loans:		
5.35% (weighted average), due 2006, fixed interest rate	**4**	13
1.07% (weighted average), due 2009, fixed interest rate	**72**	102
3.10% (weighted average), due 2012, fixed interest rate	**12**	14
0.83% (weighted average), due 2017, fixed interest rate	**47**	55
Capital leases:		
4.78%, due 2011, fixed interest rate	**26**	35
Convertible debt:		
-0.50% convertible bonds due 2013	**1,379**	1,379
Total long-term debt	**1,791**	1,900
Less current portion	**1,522**	133
Total long-term debt, less current portion	**269**	1,767

Long-term debt is denominated in the following currencies:

	December 31, 2005	December 31, 2004
U.S. dollar	**1,454**	1,404
Euro	**206**	324
Singapore dollar	**120**	153
Other	**11**	19
Total	**1,791**	1,900

Aggregate future maturities of total long-term debt outstanding are as follows:

	December 31, 2005

2006	**1,522**
2007	**119**
2008	**58**
2009	**30**
2010	**22**
Thereafter	**40**
Total	**1,791**

In August 2003, the Company issued $1,332 million principal amount at maturity of zero coupon unsubordinated convertible bonds due 2013. The bonds were issued with a negative yield of 0.5% that resulted in a higher principal amount at issuance of $1,400 million and net proceeds of $1,386 million. The negative yield through the first redemption right of the holder totals $21 million and has been recorded in capital surplus. The bonds are convertible at any time by the holders at the rate of 29.9144 shares of the Company s common stock for each one thousand dollar face value of the bonds. The holders may redeem their convertible bonds on August 5, 2006 at a price of $985.09, on August 5, 2008 at $975.28 and on August 5, 2010 at $965.56 per one thousand dollar face value of the notes. As a result of this holder s redemption option in August 2006, the

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outstanding amount of 2013 Bonds was classified in the consolidated balance sheet as current portion of long-term debt as of December 31, 2005. At any time from August 20, 2006 the Company may redeem for cash at their negative accreted value all or a portion of the convertible bonds subject to the level of the Company s share price.

Credit facilities

The Company has revolving line of credit agreements with several financial institutions totalling $1,957 million at December 31, 2005. At December 31, 2005, amounts available under the lines of credit were reduced by borrowings of $11 million at a weighted average interest rate of 4.40%.

15 SHAREHOLDERS EQUITY

15.1 Outstanding shares

The authorized share capital of the Company is EUR 1,810 million consisting of 1,200,000,000 common shares and 540,000,000 preference shares, each with a nominal value of EUR 1.04. As of December 31, 2005 the number of shares of common stock issued was 907,824,279 shares (905,308,997 at December 31, 2004).

As of December 31, 2005 the number of shares of common stock outstanding was 894,424,279 (891,908,997 at December 31, 2004).

15.2 Preference shares

The 540,000,000 preference shares entitle a holder to full voting rights and to a preferential right to dividends and distributions upon liquidation. The Company holds an option agreement with STMicroelectronics Holding II B.V. in order to protect the Company from a hostile takeover or other similar action. The option agreement provides for 540,000,000 preference shares to be issued to STMicroelectronics Holding II B.V. upon their request based on approval by the Company s Supervisory Board. STMicroelectronics Holding II B.V. would be required to pay at least 25% of the par value of the preference shares to be issued, and to retain ownership of at least 30% of the Company s issued share capital. An amendment was signed in November 2004 which reduced the threshold required for STMicroelectronics Holding II B.V. to exercise its preference shares of the Company down to 19% issued share capital from the previous requirement of at least 30%. There were no preference shares issued as of December 31, 2005.

15.3 Treasury shares

In 2002 and 2001, the Company repurchased 13,400,000 of its own shares, for a total amount of $348 million, which were reflected at cost as a reduction of the shareholders equity. No treasury shares were acquired in 2003, 2004 and 2005.

Treasury shares of 4,100,000 have been designated to be used for the Company s share-based remuneration programs on nonvested shares as decided in 2005. As of December 31, 2005, none of the common shares repurchased had been transferred to employees under the Company s share-based remuneration programs.

15.4 Stock option plans

In 1995, the Shareholders voted to adopt the 1995 Employee Stock Option Plan (the 1995 Plan) whereby options for up to 33,000,000 shares may be granted in installments over a five-year period. Under the 1995 Plan, the options may be granted to purchase shares of common stock at a price not lower than the market price of the shares on the date of grant. At December 31, 2005, under the 1995 plan, 10,106,151 of the granted options outstanding originally vest 50% after three years and 50% after four years following the date of the grant; 6,417,880 of the granted options vest 32% after two years, 32% after three years and 36% after four years following the date of the grant. The options expire 10 years after the date of grant. During 2005, the vesting periods for all options under the plan were accelerated with no impact on the income statement.

In 1996, the Shareholders voted to adopt the Supervisory Board Option Plan whereby each member of the Supervisory Board was eligible to receive, during the three-year period 1996-1998, 18,000 options for 1996 and 9,000 options for both 1997 and 1998 to purchase shares of common stock at the closing market price of the shares on the date of the grant. In the same three-year period, the professional advisors to the Supervisory Board

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were eligible to receive 9,000 options for 1996 and 4,500 options for both 1997 and 1998. Under the Plan, the options vest over one year and are exercisable for a period expiring eight years from the date of grant.

In 1999, the Shareholders voted to renew the Supervisory Board Option Plan whereby each member of the Supervisory Board may receive, during the three-year period 1999-2001, 18,000 options for 1999 and 9,000 options for both 2000 and 2001 to purchase shares of capital stock at the closing market price of the shares on the date of the grant. In the same three-year period, the professional advisors to the Supervisory Board may receive 9,000 options for 1999 and 4,500 options for both 2000 and 2001. Under the Plan, the options vest over one year and are exercisable for a period expiring eight years from the date of grant.

In 2001, the Shareholders voted to adopt the 2001 Employee Stock Option Plan (the 2001 Plan) whereby options for up to 60,000,000 shares may be granted in installments over a five-year period. The options may be granted to purchase shares of common stock at a price not lower than the market price of the shares on the date of grant. In connection with a revision of its equity-based compensation policy, the Company decided in 2005 to accelerate the vesting period of all outstanding unvested stock options. The options expire ten years after the date of grant.

In 2002, the Shareholders voted to adopt a Stock Option Plan for Supervisory Board Members and Professionals of the Supervisory Board. Under this plan, 12,000 options can be granted per year to each member of the Supervisory Board and 6,000 options per year to each professional advisor to the Supervisory Board. Options will vest 30 days after the date of grant. The options expire ten years after the date of grant.

A summary of stock option activity for the plans for the three years ended December 31, 2005, 2004 and 2003 follows:

		Price Per Share	
	Number of Shares	Range	Weighted Average
Outstanding at December 31, 2002	46,817,761	$ 6.04-$62.01	$ 32.01
Options granted:			
2001 Plan	11,976,310	$ 19.18-$25.90	$ 19.35
Supervisory Board Plan	132,000	$ 19.18	$ 19.18
Options forfeited	(898,456)	$ 6.04-$62.01	$ 37.09
Options exercised	(1,258,318)	$ 6.04-$24.88	$ 10.04
Outstanding at December 31, 2003	56,769,297	$ 6.04-$62.01	$ 29.71
Options granted:			
2001 Plan	12,365,280	$ 17.08-$27.21	$ 22.66
Supervisory Board Plan	132,000	$ 22.71	$ 22.71
Options forfeited	(1,304,969)	$ 6.04-$62.01	$ 29.20
Options exercised	(2,537,401)	$ 6.04-$24.88	$ 8.93
Outstanding at December 31, 2004	65,424,207	$ 12.03-$62.01	$ 29.18
Options granted:			
2001 Plan	42,200	$ 16.73-$17.31	$ 16.91
Supervisory Board Plan			
Options forfeited	(2,364,862)	$ 12.03-$62.01	$ 29.65
Options exercised	(2,542,978)	$ 12.03-$14.23	$ 13.88
Outstanding at December 31, 2005	**60,558,567**	$ 12.03-$62.01	$ 29.80

Stock options exercisable following acceleration of vesting for all outstanding unvested stock options were as follows:

	December 31, 2005	December 31, 2004	December 31, 2003
Options exercisable	**60,558,567**	32,212,680	23,338,811
Weighted average exercise price	$ 29.80	$ 33.84	$ 28.87

The weighted average remaining contractual life of options outstanding as of December 31, 2005, 2004 and 2003 was 5.5, 6.3 and 6.4 years, respectively.

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The range of exercise prices, the weighted average exercise price and the weighted average remaining contractual life of options exercisable as of December 31, 2005 were as follows:

Number of shares	Option price range	Weighted average exercise price	Weighted average remaining contractual life
2,523,511	$ 12.03-$17.31	$ 12.43	1.2
30,682,918	$ 19.18-$24.88	$ 22.03	6.2
236,990	$ 25.90-$29.70	$ 27.18	7.3
20,679,858	$ 31.09-$44.00	$ 34.37	5.9
6,435,290	$ 50.69-$62.01	$ 59.08	2.6

15.5 Employee share purchase plans

In 2003, the Company offered to certain of its employees worldwide the right to acquire shares of capital stock:

	Number of shares offered per employee	Price per share		Discount from the market price	Number of shares issued
		In U.S. Dollars	In Euro		
June 2003	309	17.91	15.51	15%	587,862

No employee share purchase plan was offered in 2005 and 2004.

15.6 Nonvested share awards

Additionally, on October 25, 2005 the Company granted 3,940,065 nonvested shares to senior executives, selected employees and members of the Supervisory Board, to be issued upon vesting from treasury stock. The shares were granted for free to employees. The shares granted to the employees will vest upon completion of market or internal performance conditions. Under the program, if the defined market condition is met in the first quarter of 2006, each employee will receive 100% of the nonvested shares granted. If the market condition is not achieved, the employee can earn one-third of the grant for each of the two performance conditions. If neither the market or performance conditions are met, the employee will receive none of the grant. In addition to the market and performance conditions, the nonvested shares will vest over a requisite service period: 32% after 6 months, 32% after 18 months and 36% after 30 months following the date of the grant. At December 31, 2005, 3,914,220 nonvested shares were outstanding.

On October 25, 2005, the Compensation Committee granted 66,000 stock-based awards to the members of the Supervisory Board and professionals of the Supervisory Board. These awards are granted at the nominal value of the share of 1.04 and are not subject to any vesting conditions. Their associated compensation cost was recorded immediately at grant. As of December 31, 2005, 51,000 awards were outstanding.

A summary of the nonvested share activity for the year ended December 31, 2005 is presented below:

Nonvested Shares	Number of Shares	Price

Outstanding at December 31, 2004		
Awards granted:		
Amended 2001 Plan	3,940,065	$ 0
Supervisory Board Plan	66,000	1.04
Awards cancelled:		
Amended 2001 Plan	(25,845)	$ 0
Supervisory Board Plan	(15,000)	1.04
Awards exercised		
Outstanding at December 31, 2005	**3,965,220**	$ 0- 1.04

The Company recorded compensation expense for the nonvested share awards based on the fair value of the awards at the grant date, which represents the $16.61 share price at the date of the grant. The fair value of the

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nonvested shares affected by a market condition, reflects a discount of 49.50%, using a Monte Carlo path-dependent pricing model to measure the probability of achieving the market condition.

The following assumptions were incorporated into the Monte Carlo pricing model to estimate the 49.50% discount:

	2005 grant
Historical share price volatility	27.74%
Historical volatility of reference index	25.5%
Three-year average dividend yield	0.55%
Risk-free interest rates used	4.21%-4.33%

Consistent with fair value calculations of stock option grants in prior years, the Company has determined the historical share price volatility to be the most appropriate estimate of future price activity. The weighted average grant-date fair value of nonvested shares granted in 2005 was $8.50.

The following table illustrates the classification of stock-based compensation included in the statement of income for the year ended at December 31, 2005:

Selling, general and administrative	$	6 million
Research and development	$	3 million
Total stock-based compensation expense	**$**	**9 million**

The compensation expense recorded for nonvested shares in 2005 included a reduction for estimated forfeitures of 6%, reflecting the historical trend of forfeitures on past stock award plans. This estimate will be adjusted for actual forfeitures. For employees eligible for retirement during the three-year requisite service period, the Company records compensation expense over the applicable shortened period.

The total deferred income tax benefit recognized in the income statement related to share-based compensation expense amounted to $2 million for the year ended December 31, 2005. Compensation cost capitalized as part of inventory was $2 million at December 31, 2005. As of December 31, 2005 there was $23 million of total unrecognized compensation cost related to the grant of nonvested shares, which is expected to be recognized over a weighted average period of ten months.

If the Company had continued to apply the intrinsic-value based method as prescribed by APB 25 instead of adopting FAS 123R, compensation expense would have been recognized on all granted nonvested shares for the intrinsic value, difference between the exercise price and the market price at the date of grant.

The following table illustrates for the year ended December 31, 2005 the differences between granting nonvested shares under the intrinsic-value based method as prescribed by APB 25 and the fair-value method after adoption of FAS 123R:

	Twelve months ended December 31, 2005	
	As reported	**Pro forma *(applying APB 25)***

Operating income	244	242
of which compensation expense before tax effect	*(9)*	*(11)*
Income before income taxes and minority interests	275	273
Net income	266	265
of which tax benefit related to compensation expense	*2*	*3*
Earnings per share (Basic)	0.30	0.30
Earnings per share (Diluted)	0.29	0.29
Net cash from operating activities	1,798	1,798
Net cash used in financing activities	(178)	(178)

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15.7 Accumulated other comprehensive income (loss)

The accumulated balances related to each component of other comprehensive income (loss) were as follows:

	Foreign currency translation income (loss)	Unrealized gain (loss) on available-for-sale securities, net of tax	Unrealized gain (loss) on derivatives, net of tax	Minimum pension liability adjustment, net of tax	Accumulated other comprehensive income (loss), net of tax
Balance as of December 31, 2002	(226)	1		(33)	(258)
Other comprehensive income (loss)	883	2		(4)	881
Balance as of December 31, 2003	657	3		(37)	623
Other comprehensive income (loss)	441	(3)	59	(4)	493
Balance as of December 31, 2004	1,098	0	59	(41)	1,116
Other comprehensive income (loss)	(770)		(72)	7	(835)
Balance as of December 31, 2005	328	0	(13)	(34)	281

15.8 Dividends

In 2005 and 2004, the Company paid a cash dividend of $0.12 per share for a total amount of $107 million each year. In 2003, the Company paid cash dividends of $0.08 per share, totalling $71 million. Upon the proposal of the Company s Management Board, the Supervisory Board decided in January 2006 to recommend for the 2006 Annual General Meeting of shareholders (AGM) the distribution of a cash dividend of $0.12 per share.

16 EARNINGS PER SHARE

For the years ended December 31, 2005, 2004 and 2003, earnings per share (EPS) was calculated as follows:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Basic EPS			
Net income	**266**	601	253

Weighted average shares outstanding	**892,760,520**	891,192,542	888,152,244
Basic EPS	**0.30**	0.67	0.29
Diluted EPS			
Net income	**266**	601	253
Convertible debt interest, net of tax	**5**	4	2
Net income adjusted	**271**	605	255
Weighted average shares outstanding	**892,760,520**	891,192,542	888,152,244
Dilutive effect of stock options	**854,523**	2,038,369	7,059,127
Dilutive effect of nonvested shares	**116,233**		
Dilutive effect of convertible debt	**41,880,104**	41,880,160	41,880,160
Number of shares used in calculating diluted EPS	**935,611,380**	935,111,071	937,091,531
Diluted EPS	**0.29**	0.65	0.27

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At December 31, 2005, 2004 and 2003, outstanding stock options included anti-dilutive shares totalling approximately 59,704,044 shares, 63,385,838 shares and 49,710,170 shares, respectively.

17 OTHER INCOME AND EXPENSES, NET

Other income and expenses, net consisted of the following:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Research and development funding	**76**	84	76
Start-up costs	**(56)**	(63)	(55)
Exchange gain (loss), net	**(16)**	33	5
Patent litigation costs	**(14)**	(31)	(24)
Patent pre-litigation costs	**(8)**	(6)	(5)
Gain on sale of non-current assets	**12**	6	17
Other, net	**(3)**	(13)	(18)
Total other income and expenses, net	**(9)**	10	(4)

Patent litigation costs include legal and attorney fees and payment of claims, and patent pre-litigation costs are composed of consultancy fees and legal fees. Patent litigation costs are costs incurred in respect of pending litigation. Patent pre-litigation costs are costs incurred to prepare for licensing discussions with third parties with a view to concluding an agreement. In 2003, patent litigation costs included a $10 million provision for probable losses in connection with a dispute with a competitor, which was settled in 2004.

18 IMPAIRMENT, RESTRUCTURING CHARGES AND OTHER RELATED CLOSURE COSTS

In 2005, the Company has incurred charges related to the main following items: (i) the 150mm restructuring plan started in 2003; (ii) the streamlining of certain activities decided in the first quarter of 2005; (iii) the headcount reduction plan announced in the second quarter of 2005; and (iv) the yearly impairment review.

During the third quarter of 2003, the Company commenced a plan to restructure its 150mm fab operations and part of its back-end operations in order to improve cost competitiveness. The 150mm restructuring plan focuses on cost reduction by migrating a large part of European and U.S. 150mm production to Singapore and by upgrading production to finer geometry 200mm wafer fabs. The plan includes the discontinuation of the 150mm production of Rennes (France), the closure as soon as operationally feasible of the 150mm wafer pilot line in Castelletto (Italy) and the downsizing by approximately one-half of the 150mm wafer fab in Carrollton, Texas. Furthermore, the 150mm wafer fab productions in Agrate (Italy) and Rousset (France) will be gradually phased-out in favor of 200mm wafer ramp-ups at existing facilities in these locations, which will be expanded or upgraded to accommodate additional finer geometry wafer capacity. The Company is expecting to incur the balance of the restructuring charges related to this manufacturing restructuring plan in the second half of 2006, later than previously anticipated to accommodate unforeseen qualification requirements of the Company s customers.

In the first quarter of 2005, the Company decided to reduce its Access technology products for Customer Premises Equipment (CPE) modem products. This decision was intended to eliminate certain low volume, non-strategic product families whose returns in the current environment did not meet internal targets. Additional restructuring initiatives were also implemented in the first quarter of 2005 such as the closure of a research and development design center in Karlsruhe (Germany) and in Malvern (USA), and the discontinuation of a development project in Singapore.

In May 2005, the Company announced additional restructuring efforts to improve profitability. These initiatives will aim to reduce the Company s workforce by 3,000 outside Asia by the second half of 2006, of which 2,300 are planned for Europe. The Company plans to reorganize its European activities by optimizing on a global scale its EWS activities (wafer testing); harmonizing its support functions; streamlining its activities outside its manufacturing areas; and by disengaging from certain activities.

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In the third quarter of 2005, the Company performed the impairment test on an annual basis in order to assess the recoverability of the goodwill carrying value.

Impairment, restructuring charges and other related closure costs incurred in 2005, 2004 and 2003 are summarized as follows:

Year ended December 31, 2005	Impairment	Restructuring charges	Other related closure costs	Total impairment, restructuring charges and other related closure costs
150mm fab plan		(4)	(9)	(13)
2005 restructuring initiatives	(66)	(46)	(2)	(114)
Other	(1)			(1)
Total	**(67)**	**(50)**	**(11)**	**(128)**

Year ended December 31, 2004	Impairment	Restructuring charges	Other related closure costs	Total impairment, restructuring charges and other related closure costs
150mm fab plan		(29)	(35)	(64)
Intangible assets and investments	(8)			(8)
Other		(4)		(4)
Total	(8)	(33)	(35)	(76)

Year ended December 31, 2003	Impairment	Restructuring charges	Other related closure costs	Total impairment, restructuring charges and other related closure costs

150mm fab plan	(155)	(34)	(1)	(190)
Intangible assets and investments	(6)			(6)
Other		(9)		(9)
Total	(161)	(43)	(1)	(205)

Impairment charges

In 2005, the Company recorded impairment charges as follows:

$39 million impairment of goodwill pursuant to the decision of the Company to reduce its Access technology products for Customer Premises Equipment (CPE) modem products. The Company reports CPE business as part of the Access reporting unit, included in the Application Specific Products Group (ASG). Following the decision to discontinue a portion of this reporting unit, the Company, in compliance with FAS 142, *Goodwill and Other Intangible Assets,* reassessed the allocation of goodwill between the Access reporting unit and the business to be disposed of according to their relative fair values using market comparables;

$22 million of purchased technologies were identified without an alternative use following the discontinuation of CPE product lines;

$6 million for technologies and other intangible assets pursuant to the decision of the Company to close its research and development design center in Karlsruhe (Germany), the discontinuation of a development project in Singapore, the optimization of its EWS (wafer testing) in the United States and other intangibles determined to be obsolete.

During the year 2004, impairment charges were incurred relating to $5 million for purchased technologies primarily associated with ASG product group that were determined to be obsolete and $3 million for financial assets with other-than-temporary losses based on a valuation used for additional third party financing in the underlying investment.

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In 2003, the Company incurred impairment charges as follows:

$133 million on certain property and equipment used in its 150mm fab operations, based on the discounted expected future cash flows of the assets and market quotations for the facilities in Castelletto (Italy);

$7 million fair market adjustment on the Rancho Bernardo, California facility, based on market quotations under the held-for-sale model. This impairment charge was unrelated to the Company s plan to restructure its 150mm fab facilities, but was the consequence of a deterioration in real estate market conditions for this type of facility. The facility was sold in 2004 for approximately its carrying value;

$15 million on the planned closure of a back-end building facility based on a market quotation;

$3 million related to certain purchased technologies identified to be obsolete; and

$3 million for contractually committed future capital contributions to SuperH Inc., the joint venture formed with Renesas Technology Corp.

All fabrication sites affected by the restructuring plan are owned by the Company and, with the exception of the Rancho Bernardo, California facility, were assessed for impairment using the held-for-use model defined in Statement of Financial Accounting Standards No. 144, *Accounting for the impairment or disposal of long-term assets* (FAS 144), since these facilities did not satisfy all of the criteria required for held-for-sale status, as set forth in FAS 144.

Restructuring charges and other related closure costs

Restructuring charges and other related closure costs in 2005 are summarized as follows:

	150mm fab plan					
	Restructuring	**Other related closure costs**	**Total**	**2005 restructuring initiatives**	**Other**	**Total restructuring & other related closure costs**
Provision as at December 31, 2002						
Charges incurred in 2003	34	1	35		9	44
Amounts paid	(2)		(2)		(6)	(8)
Currency translation effect	2		2			2
Provision as at December 31, 2003	**34**	**1**	**35**		**3**	**38**
Charges incurred in 2004	32	32	64		4	68
Amounts paid	(32)	(32)	(64)		(4)	(68)
Currency translation effect	2		2			2
Provision as at December 31, 2004	**36**	**1**	**37**		**3**	**40**

Charges incurred in 2005	10	9	19	48		67
Reversal of provision	(6)		(6)			(6)
Amounts paid	(23)	(10)	(33)	(21)	(2)	(56)
Currency translation effect	(4)		(4)			(4)
Provision as at December 31, 2005	**13**		**13**	**27**	**1**	**41**

150mm fab plan:

Restructuring charges incurred in 2005 amounted to $10 million, mainly related to termination benefits, and $9 million of other closure costs for transfers of production. In 2005, management decided to continue a specific back-end fabrication line in Rennes (France), which had originally been designated for full closure. This decision resulted in a $6 million reversal of the provision relating to the 2003 restructuring plan.

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Restructuring charges in 2004 primarily related to $32 million in estimated one-time involuntary termination benefits and $32 million of other charges associated with the closure and transfers of production.

In 2003, the Company accrued for restructuring charges and other related costs of $35 million, mainly related to termination benefits for the fab plant in Rennes (France).

2005 restructuring initiatives:

The Company commenced several restructuring initiatives during 2005, including:

Pursuant to the decision of reducing its Access technology products for Customer Premises Equipment (CPE) modem products, the Company committed to an exit plan in Zaventem (Belgium) and recorded $4 million of workforce termination benefits.

In order to streamline its research and development sites, the Company decided to cease its activities in two locations, Karlsruhe (Germany) and Malvern (USA). The Company incurred, in 2005, $1 million restructuring charges corresponding to employee termination costs and $1 million of unused lease charges relating to the closure of these two sites.

In addition, charges totaling $2 million were paid in 2005 by the Company for voluntary termination benefits for certain employees. The Company also incurred a $2 million charge in 2005 related to additional restructuring initiatives, mainly in the United States and Mexico.

The Company defined a plan of reorganization and optimization of its activities. This plan focuses on workforce reduction, mainly in Europe, but will, whenever possible, encourage voluntary redundancy such as early retirement measures and other special termination arrangements with the employees. The plan also includes the non-renewal of some temporary positions. For the year ended December 31, 2005, the Company recorded a total restructuring charge for its new restructuring plan amounting to $38 million, mainly related to termination incentives for two of the Company s subsidiaries in Europe, who accepted special termination arrangements.

Other:

During the year 2004, charges totalling $4 million were paid by the Company, mainly for a voluntary termination benefit program. In 2003, certain payments were made for voluntary termination benefits in France totalling $6 million and amounts accrued for lease contract terminations in the United States totalling $3 million.

Total impairment, restructuring charges and other related closure costs:

The 2003 restructuring plan and related manufacturing initiatives are expected to be largely completed by the second half of 2006. Of the total $350 million expected pre-tax charges to be incurred under the plan, $294 million have been incurred as of December 31, 2005 ($13 million in 2005, $76 million in 2004 and $205 million in 2003).

The 2005 restructuring plan is expected to result in pre-tax charges between $175 million and $205 million, out of which $114 million have been already incurred as of December 31, 2005. The 2005 restructuring plan is expected to be completed during 2006.

In 2005, total amounts paid for restructuring and related closure costs amounted to $56 million.

The total actual costs that the Company will incur may differ from these estimates based on the timing required to complete the restructuring plan, the number of people involved, the final agreed termination benefits and the costs associated with the transfer of equipment, products and processes.

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19 INTEREST INCOME (EXPENSE), NET

Interest income (expense), net consisted of the following:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Income	**53**	41	37
Expense	**(19)**	(44)	(89)
Total	**34**	(3)	(52)

Capitalized interest was $2 million, $3 million and $2 million, in 2005, 2004 and 2003, respectively.

20 LOSS ON EXTINGUISHMENT OF CONVERTIBLE DEBT

In 2004, the Company repurchased on the market all of the remaining 3.75% zero coupon convertible bonds due in 2010 for a cash amount totalling $375 million. The repurchased convertible bonds were equivalent to 4,403,075 shares and were cancelled. In relation to this repurchase, the Company recorded a non-operating pre-tax charge in 2004 of $4 million, of which $3 million related to the price paid in excess of the repurchased convertible bonds accreted value and $1 million related to the write-off of the related bond issuance costs.

In 2003, the Company repurchased on the market approximately $1,674 million aggregate principal amount at maturity of the 3.75% zero coupon convertible bonds due in 2010. The total cash paid was approximately $1,304 million. The repurchased convertible bonds were equivalent to 15,596,824 shares and were cancelled. In relation to these repurchases, the Company recorded a one-time non-operating pre-tax charge in 2003 of $39 million, of which $30 million related to the price paid in excess of the repurchased convertible bond s accreted value and $9 million related to the write-off of bond issuance costs.

21 INCOME TAX

Income before income tax expense is comprised of the following:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Income (loss) recorded in The Netherlands	**(60)**	12	15
Income from foreign operations	**335**	660	227
Income before income tax expense	**275**	672	242

STMicroelectronics N.V. and its subsidiaries are individually liable for income taxes in their jurisdictions. Tax losses can only offset profits generated by the taxable entity incurring such loss.

Income tax benefit (expense) is comprised of the following:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003

The Netherlands taxes current	**(6)**	(6)	(4)
Foreign taxes current	**(33)**	(52)	(81)
Current taxes	**(39)**	(58)	(85)
Foreign deferred taxes	**31**	(10)	99
Income tax benefit (expense)	**(8)**	(68)	14

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The principal items comprising the differences in income taxes computed at The Netherlands statutory rate (34.5%) and the effective income tax rate are the following:

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Income tax expense computed at statutory rate	**(95)**	(232)	(83)
Permanent and other differences	**(26)**	(11)	(3)
Change in valuation allowances			(1)
Impact of final tax assessments relating to prior years	**28**	3	6
Effects of change in enacted tax on deferred taxes		18	
Current year credits	**20**	28	12
Other tax and credits	**(2)**	(3)	(5)
Benefits from tax holidays	**48**	77	67
Earnings of subsidiaries taxed at different rates	**19**	52	21
Income tax benefit (expense)	**(8)**	(68)	14

The tax holidays represent a tax exemption period aimed to attract foreign technological investment in certain tax jurisdictions. The effect of the tax benefits on basic earnings per share was $0.05, $0.09 and $0.07 for the years ended December 31, 2005, 2004 and 2003, respectively. These agreements are present in various countries and include programs that reduce up to and including 100% of taxes in years affected by the agreements. The Company s tax holidays expire at various dates through the year ending December 31, 2013.

Deferred tax assets and liabilities consisted of the following:

	December 31, 2005	December 31, 2004
Tax loss carryforwards and investment credits	**150**	162
Inventory valuation	**28**	16
Impairment and restructuring charges	**24**	35
Fixed asset depreciation in arrears	**73**	72
Receivables for government funding	**66**	69
Tax allowances granted on past capital investments	**761**	765
Pension service costs	**13**	13
Commercial accruals	**11**	15
Other temporary differences	**44**	45
Total deferred tax assets	**1,170**	1,192
Valuation allowances	**(854)**	(855)
Deferred tax assets, net	**317**	337
Accelerated fixed asset depreciation	**(116)**	(147)
Acquired intangible assets	**(7)**	(6)

Advances of government funding	**(31)**	(37)
Other temporary differences	**(18)**	(28)
Deferred tax liabilities	**(172)**	(218)
Net deferred income tax asset	**145**	119

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(in millions of U.S. dollars, except per share amounts)

As of December 31, 2005, the Company and its subsidiaries have tax loss carryforwards and investment credits that expire starting 2006, as follows:

Year	
2006	**21**
2007	**1**
2008	**1**
2009	**1**
Thereafter	**126**
Total	**150**

The Tax allowances granted on past capital investments mainly related to a 2003 agreement granting the Company certain tax credits for capital investments purchased through the year ending December 31, 2006. Any unused tax credits granted under the agreement will continue to increase yearly by a legal inflationary index (currently 7% per annum). The credits may be utilized through 2020 or later depending on the Company meeting certain program criteria. In addition to this agreement, the Company will continue to receive tax credits on future years capital investments, which may be used to offset that year s tax liabilities. However, pursuant to the inability to utilize these credits currently and in future years, the Company did not recognize any deferred tax asset on such tax allowance. As a result, there is no financial impact to the net deferred tax assets of the Company.

Tax loss carryforwards include $35 million in net operating losses acquired in business combinations, which continue to be fully provided for at December 31, 2005. Any eventual use of these tax loss carryforwards would result in a reduction of the goodwill recorded in the original business combination.

The amount of deferred tax expense (benefit) recorded as a component of other comprehensive income (loss) was $6 million benefit, $5 million expense, and $0 million in 2005, 2004, and 2003, respectively. This related primarily to the tax effects of unrealized gains (losses) on derivatives as well as minimum pension liability adjustments.

22 COMMITMENTS

The Company s commitments as of December 31, 2005 were as follows:

	Total	2006	2007	2008	2009	2010	Thereafter
			(in millions)				
Operating leases	$ 271	$ 50	$ 37	$ 32	$ 28	$ 22	$ 102
Purchase obligations	1,053	940	79	34			
Of which:							
Equipment purchase	576	*576*					
Foundry purchase	260	*260*					
Software, technology licenses and design	217	*104*	*79*	*34*			
Hynix ST Joint Venture	212	212					
Other obligations	$ 112	$ 59	$ 44	$ 3	$ 2	$ 1	$ 3
Total	**1,648**	**1,261**	**160**	**69**	**30**	**23**	**105**

The Company leases land, buildings, plants, and equipment under operating leases that expire at various dates under non-cancellable lease agreements. Operating lease expense was $61 million, $45 million and $54 million in 2005, 2004 and 2003, respectively.

As described in Note 3, the Company and Hynix Semiconductor signed on November 16, 2004 a joint-venture agreement to build a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China. The business license was obtained in April 2005 and the Company paid $38 million of capital contributions through December 31, 2005. The Company expects to fulfill its remaining financial obligations up to the total agreed contribution of $250 million in 2006. In addition, the Company is committed to grant long-term financing of $250 million to the new joint venture guaranteed by subordinated collateral of the joint venture s assets. Furthermore, the Company has contingent future loading obligations to purchase products from the joint venture,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(in millions of U.S. dollars, except per share amounts)

which have not been included in the table above because at this stage the amounts remain contingent and non-quantifiable.

Other obligations primarily relate to contractual firm commitments with respect to cooperation agreements.

Other commitments

The Company has issued guarantees totalling $204 million related to its subsidiaries debt.

23 CONTINGENCIES

The Company is subject to the possibility of loss contingencies arising in the ordinary course of business. These include but are not limited to: warranty cost on the products of the Company not covered by insurance, breach of contract claims, claims for unauthorized use of third party intellectual property, tax claims and provisions for specifically identified income tax exposures as well as claims for environmental damages. In determining loss contingencies, the Company considers the likelihood of a loss of an asset or the incurrence of a liability as well as the ability to reasonably estimate the amount of such loss or liability. An estimated loss is recorded when it is probable that a liability has been incurred and when the amount of the loss can be reasonably estimated. The Company regularly reevaluates claims to determine whether provisions need to be readjusted based on the most current information available to the Company. Changes in these evaluations could result in adverse, material impact on the Company s results of operations, cash flows or its financial position for the period in which they occur.

The Company received a tax assessment from the United States tax authorities, which is currently under an appeals process. The Company is confident that it can favourably respond to the claim and intends to vigorously defend its position. The Company believes that adequate provisions exist to cover any potential losses associated with the claim.

24 CLAIMS AND LEGAL PROCEEDINGS

The Company has received and may in the future receive communications alleging possible infringements, in particular in case of patents and similar intellectual property rights of others. Furthermore, the Company may become involved in costly litigation brought against the Company regarding patents, mask works, copyrights, trademarks or trade secrets. In the event that the outcome of any litigation would be unfavorable to the Company, the Company may be required to license the underlying intellectual property right at economically unfavorable terms and conditions, and possibly pay damages for prior use and/or face an injunction, all of which individually or in the aggregate could have a material adverse effect on the Company s results of operations, cash flows or financial position and ability to compete.

The Company is involved in various lawsuits, claims, investigations and proceedings incidental to the normal conduct of its operations, other than external patent utilization. These matters mainly include the risks associated with claims from customers or other parties and tax disputes. The Company has accrued for these loss contingencies when the loss is probable and can be estimated. The Company regularly evaluates claims and legal proceedings together with their related probable losses to determine whether they need to be adjusted based on the current information available to the Company. Legal costs associated with claims are expensed as incurred. In the event of litigation which is adversely determined with respect to the Company s interests, or in the event the Company needs to change its evaluation of a potential third-party claim, based on new evidence or communications, a material adverse effect could impact its operations or financial condition at the time it were to materialize.

During 2004, the Company has settled certain disputes with respect to claims and litigation relating to possible infringements of patents and similar intellectual property rights of others. An accrual of $10 million was recorded as at December 31, 2004 for such claims, which was paid in 2005 in accordance with the final settlements. No additional accrual has been recorded in 2005 since no other risks were estimated to result in a probable loss.

The Company is currently a party to legal proceedings including legal proceedings with SanDisk Corporation (SanDisk) and Tessera, Inc. Based on management s current assumptions made with support of the Company s outside attorneys, the Company does not believe that the SanDisk litigation will result in a

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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probable loss. Concerning Tessera litigation, it is difficult, if not impossible, to predict the outcome of the litigation.

25 FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company is exposed to changes in financial market conditions in the normal course of business due to its operations in different foreign currencies and its ongoing investing and financing activities. Market risk is the uncertainty to which future earnings or asset/liability values are exposed due to operating cash flows denominated in foreign currencies and various financial instruments used in the normal course of operations.

Treasury activities are regulated by the Company s policies, which define procedures, objectives and controls. The policies focus on the management of financial risk in terms of exposure to currency rates and interest rates. Treasury controls include systematic reporting to the Chief Executive Officer and are subject to internal audits. Most treasury activities are centralized, with any local treasury activities subject to oversight from head treasury office. The majority of cash and cash equivalents are held in U.S. dollars and are placed with financial institutions rated A or higher. Marginal amounts are held in other currencies. Foreign currency operations and hedging transactions are performed to cover commercial positions.

25.1 Foreign Currency Risk

The Company conducts its business on a global basis in various major international currencies. As a result, the Company is exposed to adverse movements in foreign currency exchange rates.

Foreign Currency Forward Contracts Not Designated as a Hedge

The Company enters into foreign currency forward contracts and currency options to reduce its exposure to changes in exchange rates and the associated risk arising from the denomination of certain assets and liabilities in foreign currencies at the Company s subsidiaries. These include receivables from international sales by various subsidiaries in foreign currencies, payables for foreign currency denominated purchases and certain other assets and liabilities arising in intercompany transactions.

At December 31, 2005, only foreign currency forward contracts were outstanding. The notional amount of these foreign currency forward contracts totalled $1,461 million and $7,013 million at December 31, 2005 and 2004, respectively. The principal currencies covered are the Euro, the U.S. dollar, the Japanese yen and the Canadian dollar.

The risk of loss associated with forward contracts is equal to the exchange rate differential from the time the contract is entered into until the time it is settled.

Foreign currency forward contracts not designated as cash flow hedge outstanding as of December 31, 2005 have remaining terms of 5 days to fourth months, maturing on average after 46 days.

Cash Flow Hedges

To further reduce its exposure to U.S. dollar exchange rate fluctuations, the Company hedged in 2005 and 2004 certain euro-denominated forecasted transactions that cover at year-end a large part of its research and development, selling, general and administrative expenses, as well as a portion of its front-end manufacturing costs of semi-finished goods.

For the year ended December 31, 2005, the Company recorded as cost of sales and operating expenses $51 million and $30 million, respectively, related to the realized loss incurred on such hedged transactions. In addition, after determining that it was not probable that certain forecasted transactions would occur by the end of the originally specified time period, the Company discontinued in the first quarter of 2005 certain of its cash flow hedges and reclassified a net loss of $37 million as other income and expenses, net into the statement of income from accumulated other comprehensive income.

The notional amount of foreign currency forward contracts designated as cash flow hedges totalled $745 million and $1,839 million at December 31, 2005 and 2004, respectively. The forecasted transactions hedged at December 31, 2005 were determined to be probable of occurrence.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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As of December 31, 2005, $13 million of deferred losses on derivative instruments, net of tax of $1 million, included in accumulated other comprehensive income are expected to be reclassified as earnings during the next six months based on the monthly forecasted research and development expenses, corporate costs and semi-finished manufacturing costs. As of December 31, 2004, $59 million of deferred gains on derivative instruments, net of tax of $5 million, included in accumulated other comprehensive income were expected to be reclassified as earnings during the next six months based on the monthly forecasted research and development expenses, corporate costs and semi-finished manufacturing costs.

Foreign currency forward contracts designated as cash flow hedges outstanding as of December 31, 2005 have remaining terms of 5 days to four months, maturing on average after 59 days.

25.2 Concentration of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of interest-bearing investments, foreign currency contracts and trade receivables. The Company places its cash and cash equivalents and certain other financial instruments with a variety of high credit quality financial institutions and has not experienced any material losses relating to such instruments. The Company invests its excess cash in accordance with its investment policy that aims at minimizing credit risk.

The Company controls the credit risks associated with financial instruments through credit approvals, investment limits and centralized monitoring procedures but does not normally require collateral or other security from the parties to financial instruments. At December 31, 2005 and 2004, one customer, the Nokia Group of companies, represented 15.7% and 15.2% of trade accounts receivable, net, respectively. Any remaining concentrations of credit risk with respect to trade receivables are limited due to the large number of customers and their dispersion across many geographic areas. The Company monitors the creditworthiness of its customers to which it grants credit terms in the normal course of business. The Company does not anticipate non-performance by counterparties, which could have a significant impact on its financial position or results of operations.

25.3 Fair value of financial instruments

The estimates of fair value were obtained using prevailing financial market information resulting from various valuation techniques.

	2005		2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt				
Bank loans (including current portion)	**412**	**400**	521	505
Convertible debt	**1,379**	**1,342**	1,379	1,326
Other receivables and assets				
Foreign exchange forward contracts	**3**	**3**	200	200
Other payables and accrued liabilities				
Foreign exchange forward contracts	**31**	**31**	109	109

The methodologies used to estimate fair value are as follows:

Cash and cash equivalents, accounts receivable, bank overdrafts, short-term borrowings, accounts payable

The carrying amounts reflected in the consolidated financial statements are reasonable estimates of fair value due to the relatively short period of time between the origination of the instruments and their expected realization.

Long-term debt and current portion of long-term debt

The fair values of long-term debt were determined based on quoted market prices, and by estimating future cash flows on a borrowing-by-borrowing basis and discounting these future cash flows using the Company s incremental borrowing rates for similar types of borrowing arrangements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Foreign exchange forward contracts

The fair values of these instruments are estimated based upon quoted market prices for the same or similar instruments.

26 RELATED PARTY TRANSACTIONS

Transactions with significant shareholders, their affiliates and other related parties were as follows:

	December 31, 2005	December 31, 2004	December 31, 2003
Sales & other services	**158**	9	10
Research and development expenses	**(48)**	(46)	(34)
Other purchases	**(16)**	(23)	(9)
Other income and expenses	**(12)**	(25)	(8)
Accounts receivable	**29**	6	2
Accounts payable	**12**	18	22
Other assets	**11**	2	

For the years ended December 31, 2004 and 2003, the related party transactions were primarily with Areva, France Telecom, Finmeccanica, Equant and Orange, which represent significant shareholders of the Company, or their subsidiaries. Moreover, the related parties information presented above also includes for the year ended December 31, 2005 transactions with Thomson. See Note 1.

In addition the Company participates in an Economic Interest Group (E.I.G.) in France with Areva and France Telecom to share the costs of certain research and development activities, which were not included in the previous table. The share of income (expense) recorded by the Company as research and development expenses incurred by E.I.G during 2005 amounted to $5 million expense, to $3 million income in 2004 and to $0 million in 2003. At December 31, 2005 and 2004, the Company had a net receivable amount of $1 million.

The Company contributed cash amounts totalling $1 million, $3 million and $4 million for the years ended December 31, 2005, 2004 and 2003, respectively, to the ST Foundation, a non-profit organization established to deliver and coordinate independent programs in line with its mission. Certain members of the Foundation s Board are senior members of the Company s management.

In addition, pursuant to the Supervisory Board s approval, the Company paid in 2005 a special contribution amounting to $4 million to a non-profit charitable institution in the field of sustainable development and social responsibility on behalf of its former President and Chief Executive Officer.

27 SEGMENT INFORMATION

The Company operates in two business areas: Semiconductors and Subsystems.

In the Semiconductors business area, the Company designs, develops, manufactures and markets a broad range of products, including discrete, memories and standard commodity components, application-specific integrated circuits (ASICs), full custom devices and semi-custom devices and application-specific standard products (ASSPs) for analog, digital, and mixed-signal applications. In addition, the Company further participates in the manufacturing value chain of Smart card products through its Incard division, which includes the production and sale of both silicon chips and Smart cards.

In the Semiconductors business area, effective January 1, 2005, the Company realigned its product groups to increase market focus and realize the full potential of its products, technologies, and sales and marketing channels. Beginning with the first quarter of 2005, the Company now reports its semiconductor sales and operating income in three segments:

Application Specific Product Groups (ASG) segment, comprised of three product lines Home, Personal and Communication (HPC), Computer Peripherals (CPG) and new Automotive Product (APG);

Memory Products Group (MPG) segment; and

Micro, Linear and Discrete Group (MLD) segment.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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The Company s principal investment and resource allocation decisions in the Semiconductor business area are for expenditures on research and development and capital investments in front-end and back-end manufacturing facilities. These decisions are not made by product groups, but on the basis of the Semiconductor Business area. All these product groups share common research and development for process technology and manufacturing capacity for most of their products.

The Company has restated its results in prior periods for illustrative comparisons of its performance by product group and by period. The segment information of 2004 and 2003 has been restated using the same principles applied to the current 2005 year. The preparation of segment information according to the new group structure requires management to make significant estimates, assumptions and judgments in determining the operating income of the new groups for the prior years. However, management believes that the prior years presentation is representative of 2005 and is using these comparatives when managing the Company.

In the Subsystems business area, the Company designs, develops, manufactures and markets subsystems and modules for the telecommunications, automotive and industrial markets including mobile phone accessories, battery chargers, ISDN power supplies and in-vehicle equipment for electronic toll payment. Based on its immateriality to its business as a whole, the Subsystems segment does not meet the requirements for a reportable segment as defined in Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FAS 131).

The following tables present the Company s consolidated net revenues and consolidated operating income by semiconductor product segment. For the computation of the Groups internal financial measurements, the Company uses certain internal rules of allocation for the costs not directly chargeable to the Groups, including cost of sales, selling, general and administrative expenses and a significant part of research and development expenses. Additionally, in compliance with its internal policies, certain cost items are not charged to the Groups, including impairment, restructuring charges and other related closure costs, start-up costs of new manufacturing facilities, some strategic and special research and development programs or other corporate-sponsored initiatives, including certain corporate level operating expenses and certain other miscellaneous charges. Starting in the first quarter of 2005, the Company allocated the start-up costs to expand its marketing and design presence in new developing areas to each Group, and the Company restated prior years results accordingly.

Net revenues by product group

	December 31, 2005	**December 31, 2004**	**December 31, 2003**
Application Specific Product Groups	**4,991**	4,902	4,405
Memory Products Group	**1,948**	1,887	1,294
Micro, Linear and Discrete Group	**1,882**	1,902	1,469
Others[1]	**61**	69	70
Total consolidated net revenues	**8,882**	8,760	7,238

[1] Includes revenues from sales of subsystems mainly and other products not allocated to product groups.

Operating Income by product group

	December 31, 2005	**December 31, 2004**	**December 31, 2003**
Application Specific Product Groups	**355**	530	582
Memory Product Group	**(118)**	42	(65)
Micro, Linear and Discrete Group	**271**	413	192
Total operating income of product groups	**508**	985	709
Others[1]	**(264)**	(302)	(375)
Total consolidated operating income	**244**	683	334

[1] Operating income (loss) of Others includes items such as impairment, restructuring charges and other related closure costs, start-up costs, and other unallocated expenses, such as: strategic or special research and development programs, certain corporate-level operating

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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expenses, certain patent claims and litigations, and other costs that are not allocated to the product groups, as well as operating earnings or losses of the Subsystems and Other Products Group. Certain costs, mainly R&D, formerly in the Others category, are now being allocated to the groups; comparable amounts reported in this category have been reclassified accordingly in the above table.

Reconciliation to consolidated operating income:

	December 31, 2005	December 31, 2004	December 31, 2003
Total operating income of product groups	**508**	985	709
Strategic R&D and other R&D programs	**(49)**	(91)	(52)
Start-up costs	**(56)**	(63)	(54)
Impairment & restructuring charges	**(128)**	(76)	(205)
Subsystems	**1**	(1)	2
One-time compensation and special contributions[1]	**(22)**		
Patents claim costs		(4)	(10)
Other non-allocated provisions[2]	**(10)**	(67)	(56)
Total operating loss Others[3]	**(264)**	(302)	(375)
Total consolidated operating income	**244**	683	334

[1] One-time compensation and special contributions to the Company s former CEO and other executives not allocated to product groups.

[2] Includes unallocated expenses such as certain corporate level operating expenses and other costs. .

[3] Operating income (loss) of Others includes items such as impairment, restructuring charges and other related closure costs, start-up costs, and other unallocated expenses, such as: strategic or special research and development programs, certain corporate-level operating expenses, certain patent claims and litigations, and other costs that are not allocated to the product groups, as well as operating earnings or losses of the Subsystems and Other Products Group. Certain costs, mainly R&D, formerly in the Others category, are now being allocated to the groups in 2005; comparable amounts reported in this category have been reclassified accordingly in the above table.

The following is a summary of operations by entities located within the indicated geographic areas for 2005, 2004 and 2003. Net revenues represent sales to third parties from the country in which each entity is located. Long-lived assets consist of property, plant and equipment, net (P,P&E, net) and intangible assets, net including goodwill. A significant portion of property, plant and equipment expenditures is attributable to front-end and back-end facilities, located in the different countries in which the Company operates. As such, the Company mainly allocates capital spending resources according to geographic areas rather than along product segment areas.

Net revenues

	December 31,	December 31,	December 31,

	2005	**2004**	**2003**
The Netherlands	**2,864**	2,702	2,084
France	**268**	359	364
Italy	**203**	254	219
USA	**1,066**	1,262	992
Singapore	**4,041**	3,671	3,192
Japan	**306**	403	337
Other countries	**134**	109	50
Total	**8,882**	8,760	7,238

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Long-lived assets

	December 31, 2005	**December 31, 2004**	**December 31, 2003**
The Netherlands	**333**	438	478
France	**1,618**	2,206	2,205
Italy	**1,698**	2,216	2,102
Other European countries	**176**	209	219
USA	**458**	414	413
Singapore	**1,684**	1,828	1,149
Malaysia	**321**	367	389
Other countries	**332**	319	257
Total	**6,620**	7,997	7,212

27 SUBSEQUENT EVENTS

On February 15, 2006, the Company launched an offering of senior zero-coupon convertible bonds due 2016 totalling gross proceeds of $928 million bearing an interest rate of 1.5%. The Company has granted an option to increase the issue size by up to 5% for a period of 30 days from settlement. Assuming full exercise of this option, gross proceeds from the offering will be up to $974 million. The notes are convertible into a maximum of 42 million underlying common shares of the Company, including the increase option. The conversion price is $23.19, based on the closing price of common shares on New York Stock Exchange on February 14, 2006 plus a 30% premium.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, STMicroelectronics N.V. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	STMicroelectronics N.V.	
Date: February 22, 2006	By:	**/s/ Carlo Bozotti**
	Name:	**Carlo Bozotti**
	Title:	**President and Chief Executive Officer and Sole Member of our Managing Board**

Enclosure: STMicroelectronics N.V. s Fourth Quarter and Full Year 2005:

Operating and Financial Review and Prospects;

Audited Consolidated Statements of Income, Statements of Cash Flow and Statements of Changes in Shareholders Equity for the years ended December 31, 2005, 2004 and 2003; Balance Sheets for the years ended December 31, 2005 and 2004 and related Notes; and

Certifications pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, submitted to the Commission on a voluntary basis.

Exhibit 12.1

VOLUNTARY CERTIFICATION

I, Carlo Bozotti, certify that:

1) I have reviewed this report on Form 6-K of STMicroelectronics N.V;

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the Unaudited Interim Consolidated Statements of Income, Balance Sheets, Statements of Cash Flow and Statements of Changes in Shareholders Equity and related Notes, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;

4) The company s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Evaluated the effectiveness of the company s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) Disclosed in this report any change in the company s internal control over financial reporting that occurred during the period covered by the report that has materially affected, or is reasonably likely to materially affect, the company s internal control over financial reporting; and

5) The company s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company s auditors and the audit committee of the company s board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company s ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company s internal control over financial reporting.

Date: February 22, 2006

By: **/s/ Carlo Bozotti**

Name: **Carlo Bozotti**

Title: **President and Chief Executive Officer and Sole Member of our Managing Board**

Exhibit 12.2

VOLUNTARY CERTIFICATION

I, Carlo Ferro, certify that:

1) I have reviewed this report on Form 6-K of STMicroelectronics N.V.;

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the Unaudited Interim Consolidated Statements of Income, Balance Sheets, Statements of Cash Flow and Statements of Changes in Shareholders Equity and related Notes, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;

4) The company s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Evaluated the effectiveness of the company s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) Disclosed in this report any change in the company s internal control over financial reporting that occurred during the period covered by the report that has materially affected, or is reasonably likely to materially affect, the company s internal control over financial reporting; and

5) The company s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company s auditors and the audit committee of the company s board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company s ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company s internal control over financial reporting.

Date: February 22, 2006

By: **/s/ Carlo Ferro**

Name: **Carlo Ferro**
Title: **Executive Vice President and Chief Financial Officer**

Exhibit 13.1

VOLUNTARY CERTIFICATION OF CARLO BOZOTTI, PRESIDENT AND CHIEF EXECUTIVE OFFICER AND SOLE MEMBER OF OUR MANAGING BOARD OF STMICROELECTRONICS N.V., AND CARLO FERRO, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER OF STMICROELECTRONICS N.V., PURSUANT TO SECTION 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Report on Form 6-K of STMicroelectronics N.V. (the Company) for the period ending December 31, 2005, as submitted to the Securities and Exchange Commission on the date hereof (the Report), the undersigned hereby certify that to the best of our knowledge:

The Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and

The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 22, 2006	By:	**/s/ Carlo Bozotti**
	Name:	**Carlo Bozotti**
	Title:	**President and Chief Executive Officer and Sole Member of our Managing Board**

Date: February 22, 2006	By:	**/s/ Carlo Ferro**
	Name:	**Carlo Ferro**
	Title:	**Executive Vice President and Chief Financial Officer**