

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

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

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 20-F**

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

OR

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

For the fiscal year ended 31 December 2010

OR

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

OR

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

Commission file number 001-15246

**LLOYDS BANKING GROUP plc**

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

**Scotland**

(Jurisdiction of Incorporation or Organization)

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

(Address of Principal Executive Offices)

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

**Title of each class**

**Name of each exchange on which  
registered**

Ordinary shares of nominal value 10 pence each, represented by American Depositary  
Shares

The New York Stock Exchange

7.75% Public Income Notes due 2050

The New York Stock Exchange

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4.875% Senior Notes due 2016  
6.375% Senior Notes due 2021  
Floating Rate Notes due 2014

The New York Stock Exchange  
The New York Stock Exchange  
The New York Stock Exchange

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

None

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

None

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

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

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

Yes  No

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

Yes  No

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

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

Yes  No

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-Accelerated filer

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

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

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

Item 17  Item 18

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

Yes  No

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## PRESENTATION OF INFORMATION

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

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

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

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

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

## BUSINESS OVERVIEW

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

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

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

<sup>1</sup> Restated in 2009 for IFRS 2 (Revised).

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

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

The acquisition of HBOS plc on 16 January 2009 had a significant effect on the comparability of the Group's financial position and results with prior periods. Profit before tax is analysed further on pages 13 to 26 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group's segments, on pages 28 to 46 on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described on page 28. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources; this reporting is on a combined businesses basis, which the Group Executive Committee feel best represents the underlying performance of the Group. These combined businesses segmental results for 2010, 2009 and 2008 are therefore

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presented in compliance with IFRS 8 but the aggregated total of the combined businesses segmental results constitutes a non-GAAP measure as defined in the SEC's Regulation G and a reconciliation of this aggregated total to the statutory income statement is therefore provided on page 47. The following table shows the results of Lloyds Banking Group's Retail, Wholesale, Wealth and International, and Insurance segments and Group Operations and Central items in the last three fiscal years, and their aggregation.

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

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

## SELECTED CONSOLIDATED FINANCIAL DATA

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

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

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

<sup>2</sup> Annual dividends comprise both interim and final dividend payments. The total dividend for the year represents the interim dividend paid during the year and the final dividend, which is paid and accounted for in the following year.



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- <sup>3</sup> Earnings per share calculations for 2008 and earlier years have also been restated for the impact of the bonus element of the share issues in 2009.
- <sup>4</sup> Translated into US dollars at the Noon Buying Rate on the date each payment was made.
- <sup>5</sup> This figure excludes the limited voting ordinary shares owned by the Lloyds TSB Foundations.
- <sup>6</sup> Averages are calculated on a monthly basis from the consolidated financial data of Lloyds Banking Group.
- <sup>7</sup> The cost:income ratio is calculated as total operating expenses as a percentage of total income (net of insurance claims).
- <sup>8</sup> Capital ratios are in accordance with Basel II requirements other than the ratios for 2007 and 2006 which reflect Basel I.
- <sup>9</sup> Capital ratios for 2008 and 2009 were restated in 2010 to reflect a prior year adjustment to available-for-sale revaluation reserves (see note 1 on page F-11).

## EXCHANGE RATES

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

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

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

	2010	2009	2008	2007	2006
US dollars per pound sterling:					
Average	<b>1.54</b>	1.57	1.84	2.01	1.86

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

## BUSINESS

### HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

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

### STRATEGY OF LLOYDS BANKING GROUP

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

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

The Group's corporate strategy is focused on:

### **DEVELOPING STRONG CUSTOMER FRANCHISES THAT ARE BASED ON DEEP CUSTOMER RELATIONSHIPS**

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

## BUSINESS

### **BUILDING A HIGH PERFORMANCE ORGANISATION**

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

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

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

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

### **MANAGING THE GROUP'S MOST VALUABLE RESOURCE, PEOPLE**

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

### **SUMMARY**

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

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

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

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

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

### **MATERIAL CONTRACTS**

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

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

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

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

#### **RIGHTS ISSUE UNDERWRITING AGREEMENT**

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

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

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

## BUSINESS

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

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

### TOP UP ISSUES UNDERWRITING AGREEMENT

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

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

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

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

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

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

## ENVIRONMENTAL MATTERS

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

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

## GOVERNANCE

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

#### **MANAGING ENVIRONMENTAL RISKS IN LENDING**

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

#### **PROJECT FINANCE: EQUATOR PRINCIPLES**

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

**BUSINESS**

Equator Principles reporting January to December 2010:

**DEALS**

CATEGORY <sup>1</sup>	A	B	C	Total
Completed		8	10	18
In progress		4		4
Not completed		5	2	7
<b>Total</b>		17	12	29

**GEOGRAPHY OF COMPLETED TRANSACTIONS**

US		3	2	5
Europe		5	8	13
Rest of World				
<b>Total</b>		8	10	18

**INDUSTRY OF COMPLETED TRANSACTIONS**

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

<sup>1</sup> Category A is higher risk; category B is medium risk; category C is lower risk.

**RESOURCE EFFICIENCY**

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

The Group also registered for the Carbon Reduction Commitment Energy Efficiency Scheme in 2010 and will now be required to purchase allowances for each tonne of energy-related CO<sub>2</sub> that it emits. This has significant cost implications for the Group which provides a further incentive to reduce carbon emissions. The Group is already working towards achieving the Carbon Trust Standard – this standard recognises organisations that are genuinely measuring and reducing CO<sub>2</sub> emissions. The Group's goal is to reduce its energy consumption by 30 per cent by 2020.

**ENGAGING OUR EMPLOYEES**

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

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

**CO<sub>2</sub> EMISSIONS (TONNES)**



	2010	2009
Total UK CO <sub>2</sub> emissions	<b>442,535</b>	449,207
Scope 1 emissions	<b>73,182</b>	76,387
Scope 2 emissions	<b>333,315</b>	343,693
Scope 3 emissions	<b>36,038</b>	29,127

For 2009, the Group has reported emissions for January to December. For 2010 and future years, the Group will report annual emissions from October to September. The Group's CO<sub>2</sub> emissions have been independently verified by environmental consultants, RPS Group.

## PROPERTIES

As at 31 December 2010, Lloyds Banking Group occupied 3,231 properties in the UK. Of these, 928 were held as freeholds, 91 as long-term leaseholds and 2,212 as short-term leaseholds. The majority of these properties are retail branches, widely distributed throughout England, Scotland and Wales. Other buildings include the Lloyds Banking Group's head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations - London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 498 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as short-term leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis, principally in North America, Europe and Asia.

## LEGAL ACTIONS AND REGULATORY MATTERS

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

## UNARRANGED OVERDRAFT CHARGES

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

## BUSINESS

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

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

## INTERCHANGE FEES

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

## PAYMENT PROTECTION INSURANCE

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

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

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

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

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

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

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

### **US SANCTIONS**

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

## BUSINESS

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

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

## CUSTOMER GOODWILL PAYMENTS

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

## INTERBANK OFFERED RATE SETTING INVESTIGATIONS

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

## OTHER LEGAL ACTIONS AND REGULATORY MATTERS

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

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

## COMPETITIVE ENVIRONMENT

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

In the retail banking market, the Group competes with banks and building societies, major retailers and internet-only providers. In the mortgage market, competitors include the traditional banks and building societies and specialist mortgage providers. The Group

competes with both UK and foreign financial institutions in the wholesale banking markets and with bancassurance, life assurance and general insurance companies in the UK insurance market.

## RECENT DEVELOPMENTS

### LLOYDS BANKING GROUP MOVES AHEAD WITH PROJECT VERDE

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

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

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

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

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

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

## BUSINESS

### **LLOYDS BANKING GROUP ANNOUNCES BOARD AND MANAGEMENT TEAM CHANGES**

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

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

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

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

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

Retail Products and Marketing.

The Lloyds TSB and Bank of Scotland Community Banks.

The Halifax Community Bank.

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

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

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

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

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

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

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

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

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

Project Verde will result in the creation of the seventh largest retail bank in the UK. The European Union, working with the UK Government, structured Project Verde to ensure the divested entity would specifically be a strong and viable competitor. Moreover,

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the Group's acceleration of the start of Project Verde is expected to identify a potential purchaser by the end of 2011.

**FIRST QUARTER 2011 TRADING UPDATE**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### OVERVIEW AND TREND INFORMATION

#### THE ECONOMY

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

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

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

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

#### IMPACT ON THE LLOYDS BANKING GROUP'S MARKETS

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CRITICAL ACCOUNTING POLICIES

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

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

## FUTURE ACCOUNTING DEVELOPMENTS

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

## RESULTS OF OPERATIONS 2010, 2009 AND 2008

## SUMMARY

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

<sup>1</sup> Restated in 2009 for IFRS 2 (Revised).

## 2010 COMPARED WITH 2009

The Group recorded a loss before tax of £2,919 million in 2010 compared to a profit of £1,042 million in 2009 as a result of the £3,200 million payment protection insurance provision (see page 32). The results in 2010 also included a pension curtailment gain of £910 million, largely offset by a customer goodwill payments provision of £500 million (see page 32) and a loss on disposal of

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businesses of £365 million. The profit in 2009 included a negative goodwill credit of £11,173 million in relation to the acquisition of HBOS plc by the Group and a fee of £2,500 million paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme. There were significant post-acquisition impairment losses in respect of the HBOS portfolios in both 2009 and 2010.

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

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

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

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### OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

**2009 COMPARED WITH 2008**

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

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

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

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

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

to £193 million in 2008, this was due primarily to higher payment protection insurance claims related to unemployment.

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



### OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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

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

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

wholesale lending in Corporate Markets and a reduction in Wealth and International; customer deposits also decreased as growth in Retail was offset by the planned reduction in higher interest paying term deposits elsewhere.

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## NET INTEREST INCOME

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

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

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

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

**2010 COMPARED WITH 2009**

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 2009 COMPARED WITH 2008

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OTHER INCOME**

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

**2010 COMPARED WITH 2009**

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 2009 COMPARED WITH 2008

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

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

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

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

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

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

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





## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## OPERATING EXPENSES

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

1 Restated in 2009 for IFRS 2 (Revised).

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 2010 COMPARED WITH 2009

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**2009 COMPARED WITH 2008**

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

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

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

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

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

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## IMPAIRMENT

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

**2010 COMPARED WITH 2009**

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

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

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

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

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

The impairment charge in respect of loans and advances to banks improved by £10 million to a credit of £13 million compared to a credit of £3 million in 2009; this reflects releases in respect of a small number of specific exposures. The impairment charge in respect of debt securities classified as loans and receivables decreased by £191 million, or 77 per cent, to £57 million in 2010

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compared to £248 million in 2009. Impairment losses in respect of available-for-sale financial assets were £496 million lower at £106 million in 2010 compared to £602 million in 2009. The charge in respect of other credit risk provisions was £32 million, or 74 per cent, higher at £75 million in 2010 compared to £43 million in 2009, as a result of a small number of specific new cases that arose in 2010.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 2009 COMPARED WITH 2008

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## TAXATION

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

**2010 COMPARED WITH 2009**

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

**2009 COMPARED WITH 2008**

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

## ECONOMIC PROFIT

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## INTEGRATION

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

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

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

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

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

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

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

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

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### LINE OF BUSINESS INFORMATION

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

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

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

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

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

- the 2008 results include the results of HBOS as if it had been acquired on 1 January 2008;

- the 2009 results assume HBOS had been owned throughout that year;

- the gain on acquisition of HBOS (in 2009) and amortisation of purchased intangible assets have been excluded; and

- the unwind of acquisition-related fair value adjustments is shown as one line in the 2010 and 2009 combined businesses income statements and has not been back-dated to 2008.

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

- the results of BankWest and St. Andrews, sold in December 2008, and the related loss on disposal; and the loss on disposal of businesses in 2010;

- integration costs;

- insurance and policyholder interests volatility;

- the Government Asset Protection Scheme (GAPS) fee paid in December 2009;

- goodwill impairment;

- the curtailment gain in 2010 in respect of the Group's defined benefit pension schemes;

- the payment protection insurance provision; and

- the customer goodwill payments provision.

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

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The results of the businesses are set out below:

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

**1. Integration costs**

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

**2. Volatility arising in insurance businesses**

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

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

Volatility comprises the following:

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

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

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

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

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

Management compensates for the limitations above by:

- (i) Monitoring closely the assumptions used to calculate the normalised return used within the calculation of insurance volatility; these assumptions are disclosed below; and
- (ii) Producing separate reports on the Group's current and forecast capital ratios.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*Insurance volatility*

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

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

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

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

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

*Policyholder interests volatility*

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

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

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

### *Group hedging arrangements*

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **3. Government Asset Protection Scheme fee**

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

### **4. Negative goodwill credit**

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

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

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

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

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

### **5. Amortisation of purchased intangibles and goodwill impairment**

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

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

The Group reviews goodwill held on its balance sheet for impairment at least annually or when events or changes in economic circumstances indicate that an impairment may have taken place. Goodwill attributable to the Group's asset finance business, for which an impairment charge of £100 million was recognised in the Group's financial statements for the year ended 31 December 2008, was again reviewed for impairment in 2009 due to the continuing uncertainties over the short-term macroeconomic

environment. As a consequence, the carrying value of the consumer finance cash generating unit within Asset Finance was reassessed resulting in an additional goodwill impairment charge of £240 million in the year ended 31 December 2009.

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

**6. Curtailment gain in respect of defined benefit pension schemes**

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

**7. Pre-acquisition results of HBOS plc**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **8. Insurance grossing adjustment**

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

### **9. Results of BankWest and St. Andrews**

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

### **10. Payment protection insurance provision**

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

### **11. Customer goodwill payments provision**

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

### **12. Loss on disposal of businesses**

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## RETAIL

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

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

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

## 2010 COMPARED WITH 2009

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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

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

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

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

**2009 COMPARED WITH 2008**

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



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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## WHOLESALE

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

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

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

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

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

## 2010 COMPARED WITH 2009

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

### 2009 COMPARED WITH 2008

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## WEALTH AND INTERNATIONAL

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

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

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

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

## 2010 COMPARED WITH 2009

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

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

### 2009 COMPARED WITH 2008

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

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

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

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

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

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

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

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





## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## INSURANCE

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

## LIFE, PENSIONS AND INVESTMENTS UK

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

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

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

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

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

## LIFE, PENSIONS AND INVESTMENTS EUROPE

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

## GENERAL INSURANCE

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 2010 COMPARED WITH 2009

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

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

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

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

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

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

### 2009 COMPARED WITH 2008

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LIFE, PENSIONS AND INVESTMENTS

## UK BUSINESS

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

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

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

**2010 COMPARED WITH 2009**

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

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

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

### **2009 COMPARED WITH 2008**

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## EUROPEAN BUSINESS

## 2010 COMPARED WITH 2009

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

## 2009 COMPARED WITH 2008

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

## NEW BUSINESS

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

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

## 2010 COMPARED WITH 2009

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



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

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

### **2009 COMPARED WITH 2008**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GENERAL INSURANCE

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

**2010 COMPARED WITH 2009**

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

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

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

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

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

**2009 COMPARED WITH 2008**

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GROUP OPERATIONS

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

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

**2010 COMPARED WITH 2009**

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

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

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

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

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

**2009 COMPARED WITH 2008**

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

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

million in 2008.

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CENTRAL ITEMS

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

Central items are comprised of three main elements:

- The residual net interest position arising from the Group's processes to allocate the following elements of net interest income to the divisions:
  - interest on the Group's equity position;
  - net interest margin cost resulting from central capital activities, primarily arising on the management of senior and subordinated debt and preference shares; and
  - cost to the Group of funding wholesale and liquidity balances.
- The charge for payments to the charitable foundations: the four independent Lloyds TSB Foundations and the independent Bank of Scotland Foundation support registered charities throughout the UK that enable people, particularly the disabled and disadvantaged, to play a fuller role in society.
- Central costs and other unallocated items: these relate to the on-going costs of central group activities including those of group corporate treasury (including the central hedge function), group internal audit, group risk, group compliance, group finance and group IT and operations.

**2010 COMPARED WITH 2009**

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

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

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

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

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

### **2009 COMPARED WITH 2008**

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**COMBINED BUSINESSES BASIS SUMMARY**

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

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

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

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

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

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



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- 1 Comprises the pension curtailment gain (£910 million), integration costs (£1,653 million) and the amortisation of purchased intangibles (£629 million).
- 2 Comprises the payment protection insurance provision (£3,200 million), the customer goodwill payments provision (£500 million) and the loss on disposal of businesses (£365 million).

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### OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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Profit (loss) before tax	760	(10,825)	755	2,349	258	(10)	(6,713)
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<sup>1</sup> Restated in 2009 for IFRS 2 (Revised).

### **2010 COMPARED WITH 2009**

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

### 2009 COMPARED WITH 2008

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

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

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

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

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

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

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

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2010 Average balance £m	2010 Interest income £m	2010 Yield %	2009 Average balance £m	2009 Interest income £m	2009 Yield %	2008 Average balance £m	2008 Interest income £m	2008 Yield %
<b>Assets</b>									
Loans and receivables:									
Loans and advances to banks	70,808	512	0.72	65,440	769	1.18	39,004	1,847	4.74
Loans and advances to customers	594,361	25,459	4.28	675,092	24,171	3.58	218,220	13,808	6.33
Debt securities	31,248	1,377	4.41	39,911	1,469	3.68	2,419	61	2.52
Lease and hire purchase receivables	9,291	626	6.74	14,165	852	6.01	9,266	706	7.62
Available-for-sale financial assets	45,519	1,311	2.88	54,926	977	1.78	25,058	1,147	4.58
Held-to-maturity investments	2,188	55	2.51						
<b>Total interest-earning assets of banking book</b>	<b>753,415</b>	<b>29,340</b>	<b>3.89</b>	<b>849,534</b>	<b>28,238</b>	<b>3.32</b>	<b>293,967</b>	<b>17,569</b>	<b>5.98</b>
Total interest-earning trading securities and other financial assets at fair value through profit or loss	65,176	2,412	3.70	59,849	2,224	3.72	24,292	1,577	6.49
<b>Total interest-earning assets</b>	<b>818,591</b>	<b>31,752</b>	<b>3.88</b>	<b>909,383</b>	<b>30,462</b>	<b>3.35</b>	<b>318,259</b>	<b>19,146</b>	<b>6.02</b>
Allowance for impairment losses on loans and advances	(17,146)			(9,551)			(2,838)		
Non-interest earning assets	220,098			164,056			60,939		
<b>Total average assets and interest income</b>	<b>1,021,543</b>	<b>31,752</b>	<b>3.11</b>	<b>1,063,888</b>	<b>30,462</b>	<b>2.86</b>	<b>376,360</b>	<b>19,146</b>	<b>5.09</b>
	2010 Average interest earning assets £m	2010 Net interest income £m	2010 Net interest margin %	2009 Average interest earning assets £m	2009 Net interest income £m	2009 Net interest margin %	2008 Average interest earning assets £m	2008 Net interest income £m	2008 Net interest margin %
<b>Average interest-earning assets and net interest income:</b>									
Banking business	753,415	12,546	1.67	849,534	9,026	1.06	293,967	7,718	2.63
Trading securities and other financial assets at fair value through profit or loss	65,176	2,172	3.33	59,849	1,706	2.85	24,292	1,151	4.74
	818,591	14,718	1.80	909,383	10,732	1.18	318,259	8,869	2.79

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Domestic			Foreign			Total		
	Average Balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
<b>2010</b>									
<b>Assets</b>									
Loans and receivables:									
Loans and advances to banks	55,288	408	0.74	15,520	104	0.67	70,808	512	0.72
Loans and advances to customers	538,329	23,433	4.35	56,032	2,026	3.62	594,361	25,459	4.28
Debt securities	29,662	1,359	4.58	1,586	18	1.13	31,248	1,377	4.41
Lease and hire purchase receivables	8,747	602	6.88	544	24	4.41	9,291	626	6.74
Available-for-sale financial assets	35,296	1,236	3.50	10,223	75	0.73	45,519	1,311	2.88
Held-to-maturity investments	2,188	55	2.51				2,188	55	2.51
Total interest-earning assets of banking book	669,510	27,093	4.05	83,905	2,247	2.68	753,415	29,340	3.89
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,472	2,208	3.71	5,704	204	3.58	65,176	2,412	3.70
<b>Total interest-earning assets</b>	<b>728,982</b>	<b>29,301</b>	<b>4.02</b>	<b>89,609</b>	<b>2,451</b>	<b>2.74</b>	<b>818,591</b>	<b>31,752</b>	<b>3.88</b>
Allowance for impairment losses on loans and advances	(13,171)			(3,975)			(17,146)		
Non-interest earning assets	215,606			4,492			220,098		
<b>Total average assets and interest income</b>	<b>931,417</b>	<b>29,301</b>	<b>3.15</b>	<b>90,126</b>	<b>2,451</b>	<b>2.72</b>	<b>1,021,543</b>	<b>31,752</b>	<b>3.11</b>
<b>Percentage of assets applicable to foreign activities (%)</b>							8.82		
	Domestic			Foreign			Total		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
<b>Liabilities and shareholders funds</b>									
Deposits by banks	24,041	219	0.91	16,877	100	0.59	40,918	319	0.78
Liabilities to banks under sale and repurchase agreements	14,933	419	2.81	5,725	94	1.64	20,658	513	2.48
Customer deposits	345,927	5,108	1.48	9,743	273	2.80	355,670	5,381	1.51
Liabilities to customers under sale and repurchase agreements	42,457	231	0.54	73			42,530	231	0.54
Debt securities in issue	204,200	5,214	2.55	29,907	619	2.07	234,107	5,833	2.49
Other interest-bearing liabilities	12,882	898	6.97				12,882	898	6.97
Subordinated liabilities	32,951	3,618	10.98	11	1	9.09	32,962	3,619	10.98
Total interest-bearing liabilities of banking book	677,391	15,707	2.32	62,336	1,087	1.74	739,727	16,794	2.27
Total interest-bearing liabilities of trading book	26,115	240	0.92				26,115	240	0.92
<b>Total interest-bearing liabilities</b>	<b>703,506</b>	<b>15,947</b>	<b>2.27</b>	<b>62,336</b>	<b>1,087</b>	<b>1.74</b>	<b>765,842</b>	<b>17,034</b>	<b>2.22</b>
<b>Interest-free liabilities</b>	<b>11,563</b>			<b>940</b>			<b>12,503</b>		



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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CHANGES IN NET INTEREST INCOME VOLUME AND RATE ANALYSIS**

The following table allocates changes in net interest income between volume and rate for 2010 compared with 2009 and for 2009 compared with 2008. Where variances have arisen from both changes in volume and rate these are allocated to volume.

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### RISK MANAGEMENT

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

#### THE GROUP'S APPROACH TO RISK (unaudited)

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

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

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

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

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

#### RISK AS A STRATEGIC DIFFERENTIATOR (unaudited)

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

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

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

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

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

#### **STATE FUNDING AND STATE AID (unaudited)**

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

### RISK GOVERNANCE

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

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

### BOARD AND COMMITTEES (audited)

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

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

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

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

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

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

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

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

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

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

The **Group Financial Crime Committee** serves as the principal Group forum for reviewing and challenging the management of financial crime risk including the overall strategy and performance. The Committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.

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

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



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### **RISK GOVERNANCE STRUCTURES (audited)**

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

### **RISK MANAGEMENT OVERSIGHT (audited)**

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

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

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

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

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### **RISK MANAGEMENT FRAMEWORK (audited)**

#### **RISK MANAGEMENT IN THE BUSINESS (audited)**

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

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

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

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

#### **RISK MANAGEMENT FRAMEWORK (audited)**

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

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

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

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

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

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

Principles – high level principles for the six primary risk drivers

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

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Detailed group policy detailed policy that applies across the Group

Divisional policy local policy that specifically applies to a division

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

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

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

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

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

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

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

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

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

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

### PRINCIPAL RISKS AND UNCERTAINTIES (audited)

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

#### Risk: Definition

#### Features

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

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

Wholesale customers (including those in Wealth and International): where companies continue to face difficult business conditions, resulting in elevated corporate default levels, illiquid

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

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

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

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### Risk: Definition

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

### Features

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

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

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

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

Evolving capital and liquidity requirements continue to be a priority for the Group. In September 2010 and further clarified in December 2010, the Basel Committee on Banking Supervision put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of capital, introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2012 and 2018.

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

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

Liquidity and funding: Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

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

Funding risk is defined as the

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risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

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

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

Risk: Definition

Features

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

Market risk is managed within a Board approved framework using a range of metrics to monitor the Group's profile against its stated appetite and potential market conditions.

The principal market risks are as follows:

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

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

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

The Group's trading activity is small relative to its peers and is not considered to be a principal risk. The average 95 per cent 1-day trading Value at Risk (VaR) was £7.4 million for 2010.

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

The major sources of insurance risk are within the insurance businesses and the staff defined benefit pension schemes.

Insurance risk is inherent in the insurance business and can be affected by customer behaviour. Insurance risks accepted relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment.

The primary insurance risk carried by the Group's defined benefit pension schemes is related to longevity.

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

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

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

The FSA continues to drive focus on conduct of business activities and has established a new approach to supervision of Conduct Risk, replacing the previous 'Treating Customers Fairly' initiative for retail customers. Under this new regime the FSA has indicated that it will seek to place greater emphasis on product governance and contract terms in general, and will seek to intervene much earlier in the product lifecycle to prevent customer detriment. The FSA also continues to carry out thematic reviews on a variety of issues across the industry as a whole, for example complaints handling. The Group actively engages with the regulatory authorities and other stakeholders on these key customer treatment challenges, which includes for example, PPI (see note 54 to the financial statements 'Contingent liabilities and commitments').

The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers. Since the acquisition of HBOS, the Group has made significant progress in aligning its approach to Treating Customers Fairly across both heritages. In addition the Group



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

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

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

Ongoing regulatory and public interest in remuneration practices

Delivery of the Group's integration commitments, and

Uncertainty about EU state aid requirements and the Independent Commission on Banking's proposals for banking reform.

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### Risk: Definition

### Features

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

The integration of the two heritage organisations continues to be one of the largest integration challenges that has been seen in the UK financial services industry. The Group's Integration Execution Board, chaired by the Group Operations Director, continues to oversee the integration process and progress is being regularly reviewed by the Group Executive Committee and Group Board. While there continue to be delivery risks to the programme, not least the risk of new regulatory requirements which may have an effect on resourcing, the Group is now two years into the integration programme and has a fully developed and functioning governance framework to manage these risks. There is a clear understanding of the phased deliverables to ensure effective delivery through to 2012.

### RISK DRIVERS (unaudited)

### RISK DRIVERS (unaudited)

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

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

### BUSINESS RISK (unaudited)

#### DEFINITION

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

#### RISK APPETITE

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

#### EXPOSURES

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

internal factors: resource capability and availability, customer treatment, service level agreements, products and funding and the risk appetite of other risk categories; and

external factors: economic, technological, political, social and ethical, environmental, legal and regulatory, market expectations, reputation and competitive behaviour.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### MEASUREMENT

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

### MITIGATION

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

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

### MONITORING

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

## CREDIT RISK

### DEFINITION (audited)

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

### RISK APPETITE (audited)

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

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

### EXPOSURES (audited)

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

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused

commitments, as most retail commitments to extend credit can be cancelled and the creditworthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are regularly monitored.

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### MEASUREMENT (audited)

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

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

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

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

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

### MITIGATION (audited)

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

### INTERNAL CONTROL

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

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

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

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

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

Controls over rating systems: The Group has established an independent team in Group Risk that sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently, and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating systems are developed by risk functions either in the business units or divisions, with the business unit managing directors having ownership of the systems. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions in their respective division.

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

### COLLATERAL

The principal collateral types for loans and advances are:

mortgages over residential and commercial real estate;

charges over business assets such as premises, inventory and accounts receivables;

charges over financial instruments such as debt securities and equities; and

guarantees received from third parties.

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

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

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

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

### MASTER NETTING AGREEMENTS

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

#### OTHER CREDIT RISK TRANSFERS

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

#### **MONITORING (audited)**

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **INTENSIVE CARE OF CUSTOMERS IN DIFFICULTY (unaudited)**

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

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

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

To support UK retail customers who are encountering financial difficulties, the Group has launched a cross-channel support programme. The Group provides support to customers in difficulty via trained colleagues in branches and dedicated telephony units, and via online guidance material. For those customers requiring more intensive help, assistance is provided through dedicated support units where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies where they have multiple credit facilities including those external to the Group, that require restructuring.

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

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

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

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

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

**Mortgage Rescue Scheme:** This is a short-term Government initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

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

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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

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

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

### **SUCCESS OF THE SCHEMES (unaudited)**

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

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

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

### **MEANS OF COMMUNICATION WITH CUSTOMERS IN DISTRESS (unaudited)**

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

Customers are informed of:

the availability of self-help via our banking websites;

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

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

mortgage product transfers and term extensions; and

short-term repayment holidays for customers in temporary difficulties.

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## THE GROUP'S CREDIT RISK PORTFOLIO

## OVERVIEW (unaudited)

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

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

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

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

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

## IMPAIRMENTS ON GROUP LOANS AND ADVANCES (audited)

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

1 Impairment provisions include collective unimpaired provisions.

**IMPAIRMENT CHARGE BY DIVISION (audited)**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### EUROPEAN SOVEREIGN EXPOSURES (unaudited)

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

### OUTLOOK GROUP (unaudited)

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

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

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

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

## RETAIL

### OVERVIEW (unaudited)

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

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

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

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

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

### RETAIL IMPAIRMENT CHARGE (audited)

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**IMPAIRED LOANS AND PROVISIONS (audited)**

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

**IMPAIRMENTS ON RETAIL LOANS AND ADVANCES (audited)****As at 31 December 2010**

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

**As at 31 December 2009**

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

<sup>1</sup> Impairment provisions include collective unimpaired provisions.

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

**RETAIL LOANS AND ADVANCES TO CUSTOMERS (audited)****As at 31 December**

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

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Unsecured:		
Credit cards	11,207	12,301
Personal loans	13,881	16,940
Bank accounts	2,624	2,629
Others, including joint ventures	200	235
<b>Total Retail gross lending</b>	<b>27,912</b>	<b>32,105</b>
<b>OUTLOOK RETAIL (unaudited)</b>	<b>368,981</b>	<b>378,005</b>

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## SECURED

## SECURED IMPAIRMENT CHARGE (unaudited)

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

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

## SECURED IMPAIRED LOANS (unaudited)

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

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

## SECURED ARREARS (unaudited)

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

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

## Greater than three months in arrears (excluding repossessions)

	Number of cases		Percentage of total mortgage accounts	
	31 December 2010 Cases	31 December 2009 Cases	31 December 2010 %	31 December 2009 %
Mainstream	55,675	57,837	2.1	2.1
Buy to let	7,577	7,557	1.8	1.9
Specialist	12,582	13,848	6.4	6.6
<b>Total</b>	<b>75,834</b>	<b>79,242</b>	<b>2.3</b>	<b>2.3</b>

## Greater than three months in arrears (excluding repossessions)

	Value of debt <sup>1</sup>		Percentage of total mortgage balances	
	31 December 2010 £m	31 December 2009 £m	31 December 2010 %	31 December 2009 %

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

<sup>1</sup> Value of debt represents total book value of mortgages in arrears but not repossessed. The stock of repossession cases rose from 2,720 at 31 December 2009 to 3,043 at 31 December 2010. This still represents a relatively low proportion of the portfolio and was broadly consistent with prior years.

#### **Secured loan to value analysis (unaudited)**

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

<sup>1</sup> Specialist lending is closed to new business and is in run-off.

**UNSECURED (unaudited)**

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

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

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

risk profile of the business.

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## WHOLESALE

## OVERVIEW (unaudited)

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

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

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

## WHOLESALE IMPAIRMENT CHARGE (audited)

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

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

## IMPAIRED LOANS AND PROVISIONS (audited)

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

## OUTLOOK WHOLESALE (unaudited)

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

Wholesale retains some material single obligor concentrations on weaker credits, especially from the heritage HBOS real estate and real estate related portfolios. These portfolios (especially the secondary and tertiary assets which comprise a large part of the heritage HBOS corporate real estate and real estate related portfolio) remain vulnerable to an increase in tenancy defaults and reduced capital values from an already depressed level, particularly in the regions. However, against our base case assumptions,

we expect our impairment charges in corporate real estate to be lower than 2010 as a result of a continuing stabilisation of the existing portfolio and actions taken in 2009 and 2010. Whilst we therefore remain cautious in respect of the outlook for 2011, we do expect a modest reduction in the total impairment charge for 2011 as a whole.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## IMPAIRMENTS ON WHOLESALE LOANS AND ADVANCES (audited)

As at 31 December 2010

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

<sup>1</sup> Impairment provisions include collective unimpaired provisions.

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

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

As at 31 December 2009

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

<sup>1</sup> Impairment provisions include collective unimpaired provisions.

**CORPORATE (unaudited)**

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

### **COMMERCIAL (unaudited)**

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

### **CORPORATE REAL ESTATE BUSINESS SUPPORT UNIT (unaudited)**

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

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

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

### **WHOLESALE EQUITY (unaudited)**

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

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

### **WHOLESALE MARKETS (unaudited)**

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

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

### **TREASURY AND TRADING (unaudited)**

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**ASSET FINANCE (unaudited)**

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

**WEALTH AND INTERNATIONAL****OVERVIEW (unaudited)**

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

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

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

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

**WEALTH AND INTERNATIONAL IMPAIRMENT CHARGE (audited)**

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

Wealth and International's impairment charge increased by £1,910 million to £5,988 million in 2010 compared with 2009.

Impairment charges as a percentage of average loans and advances to customers increased to 8.90 per cent from 6.04 per cent in 2009.

**IMPAIRED LOANS AND PROVISIONS (audited)**

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

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

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

**OUTLOOK WEALTH AND INTERNATIONAL (unaudited)**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**IMPAIRMENTS ON WEALTH AND INTERNATIONAL LOANS AND ADVANCES (audited)**

As at 31 December 2010

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

As at 31 December 2009

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

<sup>1</sup> Impairment provisions include collective unimpaired provisions.

**WEALTH (audited)**

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

**IRELAND (audited)**

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

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

**IMPAIRMENTS ON IRELAND LOANS AND ADVANCES (audited)**

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

### **AUSTRALIA (audited)**

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

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

### **WHOLESALE EUROPE (audited)**

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

### **OTHER INTERNATIONAL (audited)**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LOAN PORTFOLIO (unaudited)

## ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

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

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

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

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

<b>Total loans and advances net of allowance for impairment losses</b>	<b>561,635</b>	<b>61,234</b>	<b>622,869</b>	<b>590,409</b>	<b>71,921</b>	<b>662,330</b>
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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## SUMMARY OF LOAN LOSS EXPERIENCE

The following table analyses the movements in the allowance for impairment losses on loans and advances to banks and customers for each of the five years listed. During 2010, the Group has reviewed the detailed breakdown of movements in impairment allowances and some disclosures for the year ended 31 December 2009 have been reclassified to conform with the current year presentation.

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**RISK ELEMENTS IN THE LOAN PORTFOLIO (unaudited)**

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

**NON-PERFORMING LENDING**

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

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

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

**POTENTIAL PROBLEM LOANS**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

**INTEREST FOREGONE ON NON-PERFORMING LENDING**

The table below summarises the interest foregone on impaired lending.

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

**TROUBLED DEBT RESTRUCTURINGS**

In the US, loans whose terms have been modified due to problems with the borrower are required to be separately disclosed. If the new terms were in line with market conditions at the time of the restructuring and the restructured loan remains current as to repayment of principal and interest then the disclosure is discontinued at the end of the first year.

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

**FORBEARANCE**

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

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

**ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES**

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

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

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

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

**CROSS BORDER OUTSTANDINGS**

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

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

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

As at 31 December 2010 the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £15,714 million in total were Australia and the Netherlands.

As at 31 December 2009, there were no countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets.

As at 31 December 2008, the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £8,130 million in total, were Belgium and Germany.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### MARKET RISK (audited)

#### DEFINITION

The risk of reductions in earnings, value and/or reserves, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, inflation rates, exchange rates, credit spreads and prices for bonds, commodities, equities, property and other instruments. It arises in all areas of the Group's activities and is managed by a variety of different techniques.

#### RISK APPETITE

Market risk appetite is defined with regard to the quantum and composition of market risk that exists currently in the Group and the direction in which the Group wishes to manage this.

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

#### EXPOSURES

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products. However, some interest rate, exchange rate and credit spread positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises predominantly from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Foreign currency risk also arises from the Group's investment in its overseas operations.

The Group's insurance activities also expose it to market risk, encompassing interest rate, exchange rate, property, credit spreads and equity risk:

With Profit Funds are managed with the aim of generating rates of return consistent with policyholders' expectations and this involves the mismatch of assets and liabilities.

Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in Force see note 30 to the financial statements.)

For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.

Surplus assets are held primarily in four portfolios: (a) in the long term funds of Scottish Widows plc, Clerical Medical Investment Group Limited and their subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 43 to the financial statements.

## MEASUREMENT

The following market risk measures are used for risk reporting and setting risk appetite limits and triggers:

Value at Risk: for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used

Standard Stresses: Interest Rates 25 basis points; Equities 10 per cent; Credit Spreads relative 30 per cent widening

Bespoke Extreme Stress Scenarios: e.g. stock market crash

Both VaR and standard stress measures are also used in setting divisional market risk appetite limits and triggers.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures. Trading book VaR (1-day 99 per cent) is back-tested daily against profit and loss.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## BANKING TRADING ASSETS AND OTHER TREASURY POSITIONS

Based on the commonly used 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2010 and 2009 based on the Group's global trading positions was as detailed in the table entitled Banking trading assets and other treasury positions.

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the five risk types, which now includes inflation. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity.

## BANKING TRADING ASSETS AND OTHER TREASURY POSITIONS

As at 31 December	2010				2009
	Close £m	Average £m	Maximum £m	Minimum £m	Close restated £m
Interest rate risk	3.9	4.4	8.0	2.3	7.1
Foreign exchange risk	0.4	0.4	0.8	0.1	1.1
Equity risk			0.2		
Credit spread risk	1.6	2.4	4.3	1.2	4.1
Inflation risk	0.3	0.2	0.7		0.2
Total VaR	6.2	7.4	13.0	4.2	12.5

2009 VaR has been restated to reflect trading risk only. Risk relating to the funding of the lending business is reported in the Banking-Non-Trading section of the report.

## BANKING NON-TRADING

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates including the margin between interbank and central bank rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly using, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

The following table shows, split by material currency, Lloyds Banking Group sensitivities as at 31 December 2010 to an immediate up and down 25 basis points change to all interest rates.

## BANKING NON-TRADING

2010		2009	
Up 25bps £m	Down 25bps £m	Up 25bps £m	Down 25bps £m

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Sterling	<b>(86.9)</b>	<b>88.4</b>	66.6	(66.4)
US Dollar	<b>11.1</b>	<b>(11.4)</b>	(5.5)	5.6
Euro	<b>8.9</b>	<b>(9.0)</b>	4.4	(4.4)
Australian Dollar	<b>(1.2)</b>	<b>1.2</b>	2.2	(2.3)
Other	<b>(3.0)</b>	<b>3.1</b>	(0.2)	0.2
	<b>(71.1)</b>	<b>72.3</b>	67.5	(67.3)

Base case market value is calculated on the basis of the Lloyds Banking Group current balance sheet with re-pricing dates adjusted according to behavioural assumptions. The above sensitivities show how this projected market value would change in response to an immediate parallel shift to all relevant interest rates market and administered.

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

### PENSION SCHEMES

Management of the assets of the Group's defined benefit pension schemes is the responsibility of the Scheme Trustees, who also appoint the Scheme Actuaries to perform the triennial valuations. The Group monitors its pensions exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Pensions Strategy Committee and used in discussions with the Trustees, through whom any risk management and mitigation activity must be conducted.

The schemes' main exposures are to equity risk, real rate risk and credit spread risk. Accounting for the pension schemes under International Accounting Standard (IAS)19 spreads any adverse impacts of these risks over time.

### INSURANCE PORTFOLIOS

The Group's market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2010 and 2009. Foreign exchange risk arises predominantly from overseas holdings of equities. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## INSURANCE PORTFOLIOS

<b>As at 31 December</b>	<b>2010</b> <b>£m</b>	<b>2009</b> <b>£m</b>
Equity risk (impact of 10 per cent fall pre-tax)	<b>(367.4)</b>	(383.6)
Interest rate risk (impact of 25 basis point reduction pre-tax)	<b>82.1</b>	64.0
Credit spread risk (impact of relative 30 per cent widening)	<b>(163.0)</b>	(156.4)

## MITIGATION

Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

## BANKING NON-TRADING ACTIVITIES

Interest rate risk arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled.

## INSURANCE ACTIVITIES

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

## MONITORING

The Senior Asset and Liability Committee and the Group Market Risk Forum regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by Group Risk. Where appropriate, escalation procedures are in place.

## BANKING ACTIVITIES

Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed centrally within limits defined in the detailed Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

## INSURANCE ACTIVITIES

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group's overall risk appetite and regularly reviewed by the Senior Asset and Liability Committee and the Group Market Risk Forums:

The With Profit Funds are managed in accordance with the relevant fund s principles and practices of financial management and legal requirements.

The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.

Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

## **INSURANCE RISK (audited)**

### **DEFINITION**

The risk of reductions in earnings and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

### **RISK APPETITE**

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the direction in which the Group wishes to manage this. It takes account of the need for each entity in the Group to maintain solvency in excess of the minimum level required by the entity s jurisdictional legal or regulatory requirements.

The Group s appetite for insurance risk is reviewed and approved annually by the Board.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### EXPOSURES

The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit staff pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk carried by the Group's staff pension schemes is related to longevity.

### MEASUREMENT

Insurance risks are measured using a variety of techniques including stress and scenario testing; and, where appropriate, stochastic modelling.

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate, for example those set out in note 39 to the financial statements.

### MITIGATION

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level Committees/Boards. For the life assurance businesses the key control bodies are the Board of Scottish Widows Group Limited and the Board of HBOS Financial Services Limited with the more significant risks also being subject to review by the Group Executive Committee and/or the Lloyds Banking Group Board. For the general insurance businesses the key control bodies are the Boards of the legal entities including Lloyds TSB General Insurance Limited, St. Andrew's Insurance plc and the Irish subsidiaries, with the more significant risks again being subject to Group Executive Committee and/or Lloyds Banking Group Board review. All Group staff pension schemes issues are covered by the Group Asset and Liability Committee and the Group Business Risk Committee.

The overall insurance risk is mitigated through pooling and through diversification across large numbers of uncorrelated individuals, geographical areas, and different types of risk exposure.

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)

- Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products)

- Claims management

- Product design

- Policy wording

- Product management

- The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

The most significant insurance risks in the life assurance companies are longevity risk and persistency risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed. By their nature persistency risks are difficult to hedge.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present.

In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees to assist with the management of risk in line with the Group's risk appetite.

#### **MONITORING**

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk. Reasons for any significant divergence from experience are investigated and remedial action is taken.

Insurance risk exposures are reported and monitored regularly by the Group Executive Committee.

#### **OPERATIONAL RISK (unaudited)**

##### **DEFINITION**

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, operational inefficiencies, or from people related or external events.

There are a number of categories of operational risk:

##### **LEGAL AND REGULATORY**

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

##### **CUSTOMER TREATMENT**

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate or poor customer treatment.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### PEOPLE

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

### SUPPLIER MANAGEMENT

The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third-party suppliers.

### CUSTOMER PROCESSES

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor externally facing business processes. Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and/or system failure.

### FINANCIAL CRIME

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related legal and regulatory obligations, these losses may include censure, fines or the cost of litigation.

### MONEY LAUNDERING AND SANCTIONS

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with failure to comply with prevailing legal and regulatory obligations on activities related to money laundering, sanctions and counter terrorism, these losses may include censure, fines or the cost of litigation.

### SECURITY

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

### IT SYSTEMS

The risk of reductions in earnings and/or value through financial or reputational loss resulting from the development, delivery and maintenance of effective IT solutions.

### CHANGE

The risk of reductions in earnings and/or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

### ORGANISATIONAL INFRASTRUCTURE

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor internally facing business processes at group, divisional or business unit level. Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

### RISK APPETITE

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group's reputation.

The Group encourages and maintains an appropriately balanced legal and regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

## EXPOSURES

By its very nature, operational risks can arise from a wide range of the Group's activities that involve people, processes and systems. The Group's principal operational risks relate to the Group's ability to attract, retain and motivate its people, the rate and scale of change arising from the Group's integration programme, the way in which the Group treats its customers and the legal and regulatory environment in which it operates.

The Group continues to face risks relating to its ability to attract, retain, and develop high calibre talent, as a result of challenges arising from ongoing regulatory and public interest in remuneration practices, delivery of the Group's integration commitments; and uncertainty from EU state aid requirements and Independent Commission on Banking proposals on banking reform.

The integration programme continues to be one of the largest integration exercises undertaken by a financial services firm. The breadth of the integration programme is such that all parts of the Group are impacted to a large or small degree, with the greatest impact being on the Retail bank. Although now over two years into the successful implementation of the programme, there continue to be delivery risks as the programme moves into its final phase of execution.

Customer treatment and how the Group manages its customer relationships affects all aspects of the Group's operations and is closely aligned with achievement of the Group's strategic aim to create deep long lasting relationships with its customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies, which includes, for example PPI (see note 54 to the financial statements Contingent Liabilities and Commitments ).

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### MEASUREMENT

Both Lloyds TSB and HBOS had operational risk Advanced Measurement Approach Waivers, granted by the FSA, enabling the use of an internal capital model for calculating regulatory capital. As part of its integration programme, Lloyds Banking Group is in the process of moving to The Standardised Approach (TSA) and, in anticipation of this, calculated regulatory capital for the year ended 31 December 2010 on the basis of TSA.

### MITIGATION

The Group's operational risk management framework consists of the following key components:

Identification and categorisation of the key operational risks facing a business area.

Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed.

Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed.

Loss and incident management, capturing actions to manage any losses facing a business area.

The development of Key Risk Indicators for management reporting.

Oversight and assurance of the risk management framework in divisions and businesses.

Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

### MONITORING

Business unit risk exposure is aggregated at divisional level and reported to Group Risk where a group-wide report is prepared. The report is discussed at the monthly Group Operational and Regulatory Risk Committee. This committee can escalate matters to the Chief Risk Officer, or higher committees if appropriate.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **FINANCIAL SOUNDNESS (audited)**

Financial soundness risk has three key risk components covering liquidity and funding risk; capital risk; and financial and prudential regulatory reporting, disclosure and tax risk.

### **LIQUIDITY AND FUNDING RISK**

#### **DEFINITION (audited)**

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost. Funding risk is further defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

#### **RISK APPETITE (audited)**

Liquidity and funding risk appetite for the banking businesses is set by the Board and reviewed on an annual basis. This statement of the Group's overall appetite for liquidity risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. It is reported through various metrics that enable the Group to manage liquidity and funding constraints. The Group Chief Executive, assisted by the Group Asset and Liability Committee and its sub-committee the Senior Asset and Liability Committee, regularly reviews performance against risk appetite.

#### **EXPOSURE (audited)**

Liquidity exposure represents the amount of potential outflows in any future period less committed inflows. Liquidity is considered from both an internal and regulatory perspective.

#### **MEASUREMENT (audited)**

A series of measures are used across the Group to monitor both short and long term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. The Board approved liquidity risk appetite links a number of these measures to balance sheet progression set out in the group funding plan, with regular reporting to the Board. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Note 56(4) to the financial statements sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. This forms the foundation of the Group's liquidity controls.

#### **MITIGATION (audited)**

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term funding. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on a qualitative analysis of the market's capacity for the Group's credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to corporate customers to supplement its retail deposit base.

The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's banking businesses. The Group holds sizeable balances of high grade marketable debt securities as set out in the table entitled Group funding by type which can be sold to provide, or used to secure, additional short term funding should the need arise from either market counterparties or central bank facilities (European Central Bank, Federal Reserve, Bank of England and Reserve Bank of Australia).

**MONITORING (audited)**

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular the Group Asset and Liability Committee and the Senior Asset and Liability Committee which meet monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent oversight.

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components:

Firstly, the Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both Lloyds Banking Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.

Secondly, the Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group has invested considerable resource to ensure that it satisfies the governance, reporting and stress testing requirements of the FSA's new ILAS liquidity regime. The Group has noted the industry move towards strategic balance sheet measures of the funding profile and has started to monitor and forecast the Group's Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR). The Group is aware that the regulatory liquidity landscape is subject to potential change. Specifically, in relation to the papers issued by the Basel Committee on Banking Supervision ( 'Strengthening the resilience of the banking sector' and 'International framework for liquidity risk measurement, standards and monitoring' ) the Group has actively participated in the industry-wide consultation and calibration exercises which took place through 2010.

During the year, the individual entities within the Group, and the Group, complied with all of the externally imposed liquidity and funding requirements to which they are subject.

### LIQUIDITY AND FUNDING MANAGEMENT IN 2010 (unaudited)

During 2010 liquidity and funding remained a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and liquidity where necessary, its ability to fund its financial obligations could be affected.

The Group is reliant on both wholesale funding markets and the legacy Government and central bank facilities to support its balance sheet. The liquidity and funding challenges facing the Group over the medium term continue to be ensuring sustainable access to wholesale funding markets, and the repayment of Government and central bank facilities. The combination of a clear focus on right-sizing the balance sheet, continued development of the Group's customer deposit base, and strategic access to the capital markets will enable the Group to strengthen its funding base while reducing its overall wholesale funding requirement.

The key dependencies on successfully funding the Group's balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the Group's balance sheet; the repayment of Government and central bank facilities in accordance with the agreed terms; no more than limited further deterioration in the UK's and the Group's credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on wholesale funding markets. Additionally, the Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

During 2010, the Group further improved the diversification of funding supporting its balance sheet. Wholesale funding reduced by £27.5 billion whilst customer deposits increased by £11.3 billion, resulting in a more stable liability base. The customer loan to deposit ratio improved to 154 per cent compared with 169 per cent at 31 December 2009.

At 31 December 2010, the Group's further overall support from legacy Government and central bank facilities totalled £96.6 billion, a reduction of £60.6 billion compared with 31 December 2009. These facilities have various maturity dates, the last of which is in the fourth quarter of 2012. The Group's plan to right size the balance sheet is expected to avoid the necessity to refinance much of this. Repayment of the remaining amount will be achieved by a combination of customer deposit growth and term wholesale issuance.

### ANALYSIS OF GOVERNMENT AND CENTRAL BANK FACILITIES (audited)

As at 31 December	2010 £bn	2009 £bn
Credit Guarantee Scheme	45.4	50.0
Other	51.2	107.2
<b>Total Government and central bank facilities</b>	<b>96.6</b>	<b>157.2</b>

The Group's wholesale term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total funding) at 31 December 2010 has been maintained at 50 per cent.



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Despite the market disruption as a result of European sovereign risk concerns during 2010, the Group outperformed its term wholesale issuance plans, allowing an accelerated repayment of Government and central bank facilities and thus reducing the on-going reliance on short term funding. The Group continued to fund itself successfully in the short term money markets, extending the maturity profile of this source of funding. The Group anticipates that wholesale markets will remain vulnerable to periods of disruption during 2011. To mitigate the impact of such events, the Group has been actively diversifying its funding sources and investor base.

In June 2010, the FSA introduced a new liquidity framework (Individual Liquidity Adequacy Standards – ILAS) bringing in enhanced systems and controls, quantitative requirements, reporting requirements and stress testing. As part of the ILAS framework, the FSA has issued an Individual Liquidity Guidance (ILG) to the Group, representing a new regulatory requirement, which was effective from 1 June 2010. The Group has maintained its liquidity levels above the ILG regulatory minimum since inception.

Late in 2010, the Basel Committee on Banking Supervision refined the details of the Basel III reforms to ensure the strengthening of global liquidity standards. This supplemented the 2008 published Principles of Sound Liquidity Risk Management and Supervision (Sound Principles). These principles have been strengthened by the development of two principal liquidity measures.

The first measure promotes short term resilience of the liquidity profile by ensuring that banks have sufficient high quality liquid assets to meet potential funding outflows in a stressed environment within a one month period. This is measured by the LCR. The second promotes resilience over a longer time horizon by requiring banks to fund their activities with a more stable source of funding on a going concern basis. This is measured by NSFR which has a time horizon of one year and has been developed to ensure a sustainable maturity structure of assets and liabilities.

The Group welcomes the Basel Committee's Sound Principles. The introduction of the LCR (January 2015) and NSFR (January 2018) will raise the resilience of banks to potential liquidity shocks and provide the basis for a harmonised approach to liquidity risk management. At 31 December 2010, the Group's internal calculation of the LCR was 71 per cent and the NSFR was 88 per cent; the guidance issued by the Basel Committee is still subject to final ratification by the EU and the methodology is likely to be refined on the basis of feedback from banks and regulators during the observation period. The actions already announced to right size the balance sheet are expected to ensure compliance with the future minimum standards, which are expected to be 100 per cent for both ratios by their respective effective dates.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GROUP FUNDING POSITION (audited)

As at 31 December	2010 £bn	2009 £bn	Change %
<b>Funding requirement</b>			
Loans and advances to customers <sup>1</sup>	589.5	625.9	(6)
Loans and advances to banks <sup>2</sup>	10.5	16.1	(35)
Debt securities	25.7	32.7	(21)
Available-for-sale financial assets secondary <sup>3</sup>	25.7	37.7	(32)
Cash balances <sup>4</sup>	3.6	2.7	33
<b>Funded assets</b>	<b>655.0</b>	<b>715.1</b>	<b>(8)</b>
<b>On balance sheet primary liquidity assets<sup>5</sup></b>			
Reverse repurchase agreements	7.3	5.3	38
Balances at central banks primary	34.5	36.3	(5)
Available-for-sale financial assets primary	17.3	8.9	94
Held to maturity	7.9		
	67.0	50.5	33
Other assets <sup>6</sup>	269.6	261.7	3
<b>Total Group assets</b>	<b>991.6</b>	<b>1,027.3</b>	<b>(3)</b>
Less: Other liabilities <sup>6</sup>	(229.1)	(223.4)	3
<b>Funding requirement</b>	<b>762.5</b>	<b>803.9</b>	<b>(5)</b>
<b>Funded by</b>			
Customer deposits <sup>7</sup>	382.5	371.2	3
Wholesale funding	298.0	325.5	(8)
Repurchase agreements	35.1	63.1	(44)
Total equity	46.9	44.1	6
<b>Total funding</b>	<b>762.5</b>	<b>803.9</b>	<b>(5)</b>

<sup>1</sup> Excludes £3.1 billion (31 December 2009: £1.1 billion) of reverse repurchase agreements.

<sup>2</sup> Excludes £15.6 billion (31 December 2009: £15.1 billion) of loans and advances to banks within the insurance businesses and £4.2 billion (31 December 2009: £4.2 billion) of reverse repurchase agreements.

<sup>3</sup> Secondary liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

<sup>4</sup> Cash balances and Balances at central banks primary are combined in the Group's balance sheet.

<sup>5</sup> Primary liquidity assets are FSA eligible liquid assets including UK Gilts, US Treasuries, Euro AAA government debt and unencumbered cash balances held at central banks.

<sup>6</sup> Other assets and other liabilities primarily include balances in the Group's insurance businesses and the fair value of derivative assets and liabilities.

<sup>7</sup> Excluding repurchase agreements of £11.1 billion (31 December 2009: £35.5 billion).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GROUP FUNDING BY TYPE (audited)

As at 31 December	2010 £bn	2010 %	2009 £bn	2009 %
Deposits from banks <sup>1</sup>	26.4	3.9	48.6	7.0
Debt securities in issue <sup>1</sup> :				
Certificates of deposit	42.4	6.2	50.9	7.3
Commercial paper	32.5	4.8	35.0	5.0
Medium-term notes <sup>2</sup>	87.7	12.9	89.7	12.9
Covered bonds	32.1	4.7	28.1	4.0
Securitisation	39.0	5.7	35.8	5.1
	233.7	34.3	239.5	34.3
Subordinated liabilities <sup>1</sup>	37.9	5.6	37.4	5.4
Total wholesale funding <sup>3</sup>	298.0	43.8	325.5	46.7
Customer deposits	382.5	56.2	371.2	53.3
<b>Total Group funding<sup>4</sup></b>	<b>680.5</b>	<b>100.0</b>	<b>696.7</b>	<b>100.0</b>

<sup>1</sup> A reconciliation to the Group's balance sheet is provided on page 99.

<sup>2</sup> Medium-term notes include £45.4 billion of funding from the Credit Guarantee scheme.

<sup>3</sup> The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

<sup>4</sup> Excluding repos and total equity.

Total wholesale funding is analysed by residual maturity as follows:

## WHOLESALE FUNDING BY RESIDUAL MATURITY (audited)

As at 31 December	2010 £bn	2010 %	2009 £bn	2009 %
Less than one year	148.6	49.9	161.8	49.7
One to two years	46.8	15.7	48.8	15.0
Two to five years	52.3	17.6	68.7	21.1
More than five years	50.3	16.8	46.2	14.2
<b>Total wholesale funding</b>	<b>298.0</b>	<b>100.0</b>	<b>325.5</b>	<b>100.0</b>

## TERM ISSUANCE (audited)

The stabilisation of the term wholesale markets observed in the first quarter of 2010 and the continued functioning of these markets throughout the year, despite the European Sovereign credit concerns, enabled the Group to outperform its term issuance plan for 2010. The Group has taken advantage of the improved market sentiment by successfully accessing a number of markets, both secured and unsecured. The table below summarises the Group's term issuance during 2010. Exceeding term funding plans in 2010 contributed to the acceleration in repaying Government and central bank facilities during the year.

## ANALYSIS OF 2010 TERM ISSUANCE (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	3.5	5.2	2.1	0.7	11.5

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Medium-term notes	1.1	3.7	2.7	2.2	9.7
Covered bonds			3.7		3.7
Subordinated liabilities	0.7	2.5	1.3		4.5
Private placements <sup>1</sup>	4.6	4.6	10.6	0.8	20.6
<b>Total Issuance</b>	<b>9.9</b>	<b>16.0</b>	<b>20.4</b>	<b>3.7</b>	<b>50.0</b>

1 Private placements include structured bonds and term repurchase agreements (repos).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LIQUIDITY PORTFOLIO (audited)

The table below illustrates the Group's holding of highly liquid unencumbered assets. This liquidity is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of the Group's liquidity management process.

## LIQUIDITY PORTFOLIO (audited)

As at 31 December	2010 £bn	2009 £bn
Primary liquidity <sup>1</sup>	97.5	88.4
Secondary liquidity <sup>2</sup>	62.4	62.4
<b>Total</b>	<b>159.9</b>	<b>150.8</b>

<sup>1</sup> Primary liquidity is defined as FSA eligible liquid assets (UK Gilts, US Treasuries, Euro AAA government debt; unencumbered cash balances held at central banks).

<sup>2</sup> Secondary liquidity comprises a diversified pool of highly rated unencumbered collateral (including retained issuance). Following the introduction of the FSA's Individual Liquidity Guidance under ILAS, the Group now manages its liquidity position as a coverage ratio (proportion of stressed outflows covered by primary liquid assets) rather than by reference to a quantum of liquid assets; the liquidity position reflects a buffer over the regulatory minimum. The Group receives no recognition under ILAS for assets held for secondary liquidity purposes.

The following tables reconcile figures reported on page 98.

## RECONCILIATION OF THE COMPONENTS OF WHOLESALE FUNDING TO THE BALANCE SHEET (audited)

As at 31 December 2010	Included in funding analysis (above) £bn	Repos £bn	Fair value and other accounting methods £bn	Balance Sheet £bn
Deposits from banks	26.4	24.0		50.4
Debt securities in issue	233.7		(4.8)	228.9
Subordinated liabilities	37.9		(1.7)	36.2
Total wholesale funding	298.0	24.0		
Customer deposits	382.5	11.1		393.6
<b>Total</b>	<b>680.5</b>	<b>35.1</b>		

As at 31 December 2009	Included in funding analysis (above) £bn	Repos £bn	Fair value and other accounting methods £bn	Balance Sheet £bn
Deposits from banks	48.6	27.6	6.3	82.5
Debt securities in issue	239.5		(6.0)	233.5
Subordinated liabilities	37.4		(2.7)	34.7
Total wholesale funding	325.5	27.6		
Customer deposits	371.2	35.5		406.7
<b>Total</b>	<b>696.7</b>	<b>63.1</b>		



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CONTRACTUAL CASH OBLIGATIONS (unaudited)**

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2010.

	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Enhanced capital notes				9,235	9,235
Long-term debt - dated	1,119	1,575	2,366	14,232	19,292
Medium-term notes	31,239	34,676	7,530	14,195	87,640
Commercial paper	32,723				32,723
Covered bonds	2,930	5,242	11,626	12,352	32,150
Securitisation notes	3,841	8,003	2,102	26,796	40,742
Finance leases	1	3	2	52	58
Operating leases	356	610	510	1,706	3,182
Capital commitments	424	1			425
Other purchase obligations	1,213	1,420	856	441	3,930
	<b>73,846</b>	<b>51,530</b>	<b>24,992</b>	<b>79,009</b>	<b>229,377</b>

Other purchase obligations include amounts expected to be payable in respect of material contracts entered into by the Lloyds Banking Group, in the ordinary course of business, for the provision of outsourced and other services. The cost of these services will be charged to the income statement as it is incurred. The Lloyds Banking Group also has a constructive obligation to ensure that its defined post-retirement benefit schemes remain adequately funded. The amount and timing of the Lloyds Banking Group's cash contributions to these schemes is uncertain and will be affected by factors such as future investment returns and demographic changes. Lloyds Banking Group expects to make cash contributions of at least £625 million to these schemes in 2011.

At 31 December 2010, Lloyds Banking Group also had £7,705 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2010, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds TSB Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds TSB Bank and HBOS to pay dividends going forward, or for Lloyds TSB Bank or other Lloyds Banking Group companies to make loans to Lloyds Banking Group plc, depends on a number of factors, including their own regulatory capital requirements, distributable reserves and financial performance.

**OFF-BALANCE SHEET ARRANGEMENTS (unaudited)**

A table setting out the amounts and maturities of Lloyds Banking Group's other commercial commitments at 31 December 2010 is included in note 56 to the consolidated financial statements. These commitments are not included in Lloyds Banking Group's consolidated balance sheet.

Lending commitments are agreements to lend to customers in accordance with contractual provisions; these are either for a specified period or, as in the case of credit cards and overdrafts, represent a revolving credit facility which can be drawn down at any time, provided that the agreement has not been terminated. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

Lloyds Banking Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The contractual nominal amounts of these guarantees totalled £22,975 million at 31 December 2010 (with £12,088 million expiring within one year; £4,163 million between one and three years; £3,175 between three and five years; and £3,549 million over five years).

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Lloyds Banking Group's banking businesses are also exposed to liquidity risk through the provision of securitisation facilities to certain corporate customers. At 31 December 2010, Lloyds Banking Group offered securitisation facilities to its corporate and financial institution client base through its conduit securitisation vehicles, Argento, Cancara, Grampian and Landale. These are funded in the global asset-backed commercial paper market. The assets and obligations of these conduits are included in Lloyds Banking Group's consolidated balance sheet. Lloyds Banking Group provides short-term asset-backed commercial paper liquidity support facilities on commercial terms to the issuers of the commercial paper, for use in the event of a market disturbance should they be unable to roll over maturing commercial paper or obtain alternative sources of funding.

Details of securitisations and other special purpose entity arrangements entered into by the Group are provided in notes 22 and 23 to the consolidated financial statements. The successful development of Lloyds Banking Group's ability to securitise its own assets has provided a mechanism to tap a well established market, thereby diversifying Lloyds Banking Group's funding base.

As indicated on page F-46, the Group's securitisations include a number of synthetic securitisation arrangements. Synthetic securitisations use credit default swaps to transfer the credit risk of the underlying assets to a third party without transferring the funding requirement. As the prices of the underlying assets fall, this creates a credit risk on the third party which typically is not collateralised. The total notional amount of credit default swaps used for synthetic securitisation transactions at 31 December 2010 was £1,003 million. The Group takes a credit valuation adjustment by reserving the current mark to market of the exposure multiplied by the credit default swap spread of the counterparty for the maturity of the exposure. At 31 December 2010, the maximum exposure to default by the underlying counterparty (which is equivalent to the fair value) was £56 million, net of the credit reserves. There have been no recent changes in the methodology for assessing credit valuation reserves on credit default swaps.

Within Lloyds Banking Group's insurance businesses, the principal sources of liquidity are premiums received from policyholders, charges levied upon policyholders, investment income and the proceeds from the sale and maturity of investments. The investment policies followed by Lloyds Banking Group's life assurance companies take account of anticipated cash flow requirements including by matching the cash inflows with projected liabilities where appropriate. Cash deposits and highly liquid government securities are available to provide liquidity to cover any higher than expected cash outflows.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### CAPITAL RISK

#### DEFINITION (audited)

Capital risk is defined as the risk of the Group having a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

#### RISK APPETITE (audited)

Capital risk appetite is set by the Board and reported through various metrics that enable the Group to manage capital constraints and market expectations. The Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly reviews performance against risk appetite. A key metric is the Group's core tier 1 capital ratio. The Group's target for this and other aspects of appetite will be reviewed in 2011 in the light of further clarity of regulatory and accounting reforms.

#### EXPOSURE (audited)

A capital exposure arises where the Group has insufficient regulatory capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures whilst optimising value for shareholders.

#### MEASUREMENT (audited)

The Group's regulatory capital is divided into tiers depending on level of subordination and ability to absorb losses. Core tier 1 capital as defined in the FSA letter to the British Bankers' Association in May 2009, comprises mainly shareholders' equity and minority interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected loss over accounting provisions and certain securitisation positions. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and Available-for-Sale assets. Tier 1 capital, as defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA's General Prudential Sourcebook (GENPRU), is core tier 1 capital plus tier 1 capital securities. Tier 2 capital, defined by GENPRU, comprises qualifying subordinated debt after deducting 50 per cent of the excess of expected loss over accounting provisions, and certain securitisation positions. Total capital is the sum of tier 1 and tier 2 capital after deducting investments in subsidiaries and associates that are not consolidated for regulatory purposes. In the case of Lloyds Banking Group, this means that the net assets of its life assurance and general insurance businesses and the non-financial entities that are held by our private equity (including venture capital) businesses, are excluded from its total regulatory capital.

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities; for example the amount of qualifying tier 2 capital cannot exceed that of tier 1 capital.

The minimum total capital required under pillar 1 of the Basel II framework is the Capital Resources Requirement (CRR) calculated as 8 per cent of risk weighted assets.

In order to address the requirements of pillar 2 of the Basel II framework, the FSA currently sets additional minimum requirements through the issuance of Individual Capital Guidance (ICG) for each UK bank calibrated by reference to the CRR. A key input into the FSA's ICG setting process is each bank's Internal Capital Adequacy Assessment Process. The Group has been given an ICG by the FSA and the Group maintains a buffer in addition to this requirement. The FSA has made it clear that ICG remains a confidential matter between each bank and the FSA.

In addition to the minimum requirements for total capital, the FSA has made statements to explain it also operates a framework of targets and expected buffers for core tier 1 and tier 1.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group seeks to ensure that the regulatory minimum requirements are met at all times and undertakes an extensive series of stress analyses during the year to determine the adequacy of the Group's capital resources against the FSA minimum requirements in severe economic conditions.

During 2010 the Basel Committee on Banking Supervision has substantially refined the details of the so called 'Basel III' reforms for an enhanced global capital accord. These include increased minimum levels of and quality standards for capital, increased risk weighting of assets, and the introduction of a minimum leverage ratio, as well as the timing and transitional arrangements for implementation. The final details are still to be clarified, particularly as the reforms are implemented within the European and UK regulations, which may include a countercyclical buffer, requiring higher levels of capital to be held at certain points of the economic cycle, and higher capital requirements for systemically important financial institutions.

The effect of the Basel III reforms is uncertain as much will depend on business performance and mitigating actions that can be completed, even before the transition period comes in to effect. However lower risk weighted assets are expected from the planned reduction in the balance sheet. Analysis suggests that with no mitigating actions the reforms will reduce the Group's core tier 1 ratio by approximately 1.2 per cent in 2013. The additional impact in 2014 of deducting the equity investment in insurance in excess of 10 per cent, transitioning in at 20 per cent per annum from 1 January 2014, would be around 0.3 per cent were the Group to take no further action to mitigate this. The Group is confident that it is well positioned to maintain a strong capital position, meeting all regulatory requirements as currently formulated.

### **MITIGATION (audited)**

The Group has developed procedures to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite.

The Group is able to accumulate additional capital through profit retention, by raising equity via, for example, a rights issue or debt exchange and by raising tier 1 and tier 2 capital by issuing subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time.

The Group has in issue as part of tier 2 capital resources, enhanced capital notes which will convert to core tier 1 capital in the event that the Group's published core tier 1 ratio (as defined by the FSA in May 2009) falls below 5 per cent.

Additional measures which have been used to manage the Group's capital position include seeking to strike an appropriate balance of capital held within its insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises. Regulatory requirements are primarily controlled through the quality and volume of lending but are also affected through the modelling approaches used to determine risk weighted assets and expected losses.

### **MONITORING (audited)**

Capital is actively managed and regulatory ratios are a key factor in the Group's budgeting and planning processes. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those that would occur under stressed scenarios, is made to the Senior Asset and Liability Committee, the Group Asset and Liability Committee and the Board.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CAPITAL RESOURCES

As at 31 December	2010 £m	2009 <sup>1</sup> £m
<b>Core tier 1</b>		
Ordinary share capital and reserves	44,543	44,275
Regulatory post-retirement benefit adjustments	(1,052)	434
Available-for-sale revaluation reserve	285	783
Cash flow hedging reserve	391	305
Other items	306	231
	<b>44,473</b>	46,028
<b>Less: deductions from core tier 1</b>		
Goodwill and other intangible assets	(5,224)	(5,779)
Other deductions	(214)	(445)
<b>Core tier 1 capital (audited)</b>	<b>39,035</b>	39,804
<b>Perpetual non-cumulative preference shares</b>		
Preference share capital <sup>2</sup>	1,507	2,639
<b>Innovative tier 1 capital instruments</b>		
Preferred securities <sup>2</sup>	4,338	4,956
<b>Less: deductions from tier 1</b>		
Other deductions	(69)	
<b>Total tier 1 capital (audited)</b>	<b>44,811</b>	47,399
<b>Tier 2</b>		
Available-for-sale revaluation reserve in respect of equities	462	221
Undated subordinated debt	1,968	2,575
Eligible provisions	2,468	2,694
Dated subordinated debt	23,167	20,068
Less: restriction in amount eligible	(620)	
<b>Deductions from tier 2</b>		
Other deductions	(283)	(445)
<b>Total tier 2 capital (audited)</b>	<b>27,162</b>	25,113
<b>Supervisory deductions</b>		
Unconsolidated investments life	(10,042)	(10,015)
Unconsolidated investments general insurance and other	(3,070)	(1,551)
<b>Total supervisory deductions (audited)</b>	<b>(13,112)</b>	(11,566)
<b>Total capital resources (audited)</b>	<b>58,861</b>	60,946
<b>Risk-weighted assets (unaudited)</b>	<b>406,372</b>	493,307
<b>Ratios (unaudited)</b>		
<b>Core tier 1 ratio</b>	<b>9.6%</b>	8.1%
<b>Tier 1 capital ratio</b>	<b>11.0%</b>	9.6%
<b>Total capital ratio</b>	<b>14.5%</b>	12.4%

1 Restated to reflect a prior year adjustment to available-for-sale revaluation reserves (see note 1 to the consolidated financial statements).

2 Covered by grandfathering provisions issued by the FSA.

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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**TIER 1 CAPITAL (audited)**

Core tier 1 capital decreased by £769 million largely reflecting the loss for the year, which more than offset the issue of ordinary shares in exchange for certain preference shares, preferred securities and undated subordinated debt issued by the Group. This has been compounded by a deduction in respect of post-retirement benefits reflecting the impact of the curtailment gain, which is not allowed for capital purposes and a commitment to make increased deficit contributions to the HBOS final salary pension scheme following the completion of an actuarial valuation.

Tier 1 capital has decreased by 2,588 million over the year; due to the decrease in core tier 1 capital together with the redemption of the preference shares and preferred securities as part of the liability management exercises referred to above.

**MOVEMENTS IN CORE TIER 1 AND TIER 1 CAPITAL DURING THE YEAR (audited)**

	Core tier 1 £m	Tier 1 £m
At 31 December 2009	39,804	47,399
Loss attributable to ordinary shareholders	<b>(2,656)</b>	<b>(2,656)</b>
Issue of ordinary shares	<b>2,237</b>	<b>2,237</b>
Increase in regulatory post-retirement benefit adjustments	<b>(1,486)</b>	<b>(1,486)</b>
Redemption of preference shares and preferred securities		<b>(1,869)</b>
Decrease in goodwill, intangible assets and other deductions	<b>786</b>	<b>717</b>
Other movements	<b>350</b>	<b>469</b>
<b>At 31 December 2010</b>	<b>39,035</b>	<b>44,811</b>

**TIER 2 CAPITAL (audited)**

Tier 2 capital has increased principally as a result of new issues of tier 2 debt, net of a restriction in the amount eligible, and favourable foreign exchange rate movements partially offset by the redemption of undated subordinated debt described above, amortisation for regulatory purposes of dated subordinated debt and lower eligible provisions.

**SUPERVISORY DEDUCTIONS (audited)**

Supervisory deductions mainly consist of investments in subsidiary undertakings that are not within the banking group for regulatory purposes. These investments are primarily the Scottish Widows and Clerical Medical life and pensions businesses, together with the general insurance business. Supervisory deductions relating to these businesses have benefitted from repatriation of capital during the year. Also included within deductions for other unconsolidated investments at 31 December 2010 are investments in non-financial entities that are held by our private equity (including venture capital) businesses. These investments were previously risk weighted in accordance with industry wide guidance provided by the FSA. This guidance has now expired.

**RISK WEIGHTED ASSETS (unaudited)**

The following table sets out the Group's risk weighted assets that primarily arise in its banking businesses.

**ANALYSIS OF RISK WEIGHTED ASSETS (unaudited)**

As at 31 December	2010 £m	2009 £m
<b>Divisional analysis of risk weighted assets</b>		
Retail	<b>109,254</b>	128,592
Wholesale	<b>222,716</b>	285,951

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Wealth and International	<b>58,714</b>	63,249
Group Operations and Central items	<b>15,688</b>	15,515
	<b>406,372</b>	493,307

**Risk type analysis of risk weighted assets**

Advanced IRB		92,076
Foundation IRB	<b>114,490</b>	67,621
Retail IRB	<b>105,475</b>	124,503
Other IRB	<b>14,483</b>	22,418
Advanced Approach	<b>234,448</b>	306,618
Standardised Approach	<b>124,492</b>	145,486
Credit risk	<b>358,940</b>	452,104
Operational risk	<b>31,650</b>	25,339
Market and counterparty risk	<b>15,782</b>	15,864
<b>Total risk weighted assets</b>	<b>406,372</b>	493,307

Risk weighted assets decreased by £86,935 million to £406,372 million. This reflects balance sheet reductions across all banking divisions, a revised assessment of Retail secured lending risk weighted assets following improvements in the economic outlook and changes introduced as a result of continuing the process of integrating the two heritage organisations regulatory capital approaches which have impacted particularly on Wholesale.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The FSA has issued the Group an integrated waiver direction effective from 31 December 2010. The principal changes resulting from this are to move the heritage HBOS non-retail Advanced IRB portfolios to a Foundation IRB approach. All material retail portfolios across the Group remain on Retail IRB. In anticipation of moving to The Standardised Approach (TSA) for measurement of operational risk, the Group has calculated operational risk weighted assets on the basis of TSA.

The Group has adopted Foundation IRB as the interim capital calculation approach for all non-retail exposures in Wholesale and Wealth and International. The Group has adopted the Lloyds TSB relationship model and risk appetite and many of its risk management models and methodologies and as such, believe that converging on Foundation IRB will facilitate integration work. This change has resulted in a reduction in risk weighted assets of approximately £23 billion.

## FINANCIAL AND PRUDENTIAL REGULATORY REPORTING, DISCLOSURE AND TAX RISK (audited)

### DEFINITION

The risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial, prudential regulatory and tax reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate information about the Group on a timely basis.

### RISK APPETITE

The risk appetite is set by the Board and reviewed on an annual basis. It includes complying with disclosure requirements within prescribed timescales and avoiding the need for restatement of published financial, prudential regulatory and tax reporting or publicly disclosed information.

### EXPOSURE

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate books and records to support statutory, prudential and tax reporting, to prevent and detect financial reporting fraud and to manage the Group's tax position.

### MITIGATION

The Group maintains a system of internal controls, which is designed to be consistently applied and to enable the preparation and disclosure of financial, prudential regulatory and tax reporting in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements. The system of internal control is designed to ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded.

### MONITORING

The Group has in place a disclosure committee whose responsibility is to review all significant disclosures made by the Group and to assist the Group Chief Executive and Group Finance Director fulfil their responsibilities under the Listing Rules and regulations emanating from the US Sarbanes Oxley Act of 2002. A programme of work designed to support an annual assessment of the effectiveness of internal controls over financial reporting, in accordance with the requirements of section 404 of the US Sarbanes Oxley Act is undertaken. The Group also has in place an assurance mechanism over its prudential regulatory reporting; additionally, monitoring activities are designed to identify and maintain tax liabilities and to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### LIFE INSURANCE BUSINESSES (audited)

The business transacted by the life insurance companies within the Group comprises unit-linked business, non profit business and with-profits business. Several companies transact either unit-linked and/or non-profit business, but Scottish Widows plc (Scottish Widows) and Clerical Medical Investment Group Limited (Clerical Medical) hold the only large With Profit Funds managed by the Group.

### BASIS OF DETERMINING REGULATORY CAPITAL OF THE LIFE INSURANCE BUSINESSES (audited)

#### AVAILABLE CAPITAL RESOURCES

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the FSA.

**Statutory basis.** Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. If the market is not active, the Group establishes a fair value by using valuation techniques. Liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

#### REGULATORY CAPITAL REQUIREMENTS

Each life insurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the FSA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows and Clerical Medical, the regulatory capital requirement is a combination of amounts held in respect of actuarial reserves, sums at risk and maintenance expenses (the Long-Term Insurance Capital Requirement) and amounts required to cover various stress tests (the Resilience Capital Requirement). The regulatory capital requirement is deducted from the available capital resources to give statutory excess capital .

For Scottish Widows and Clerical Medical, no Resilience Capital Requirement is required. However, a further test is required in respect of the With Profit Funds. This involves comparing the statutory basis of assessment with a realistic basis of assessment as described below.

**Realistic basis.** The FSA requires each life insurance company which contains a With Profit Fund in excess of £500 million to also carry out a realistic valuation of that fund. The Group has two such funds; one within Scottish Widows and one within Clerical Medical. The word realistic in this context reflects the fact that assumptions are best-estimate as opposed to prudent. This realistic valuation is an assessment of the financial position of a With Profit Fund calculated under a methodology prescribed by the FSA.

The valuation of with-profits assets in a With Profit Fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profits business written in a With Profit Fund (a relatively small amount of business in the case of Scottish Widows and Clerical Medical), it includes the present value of the anticipated future release of the prudent margins for adverse deviation. In addition, the realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities includes an allowance for future bonuses. Options and guarantees are valued using a stochastic simulation model which values these liabilities on a basis consistent with tradable market option contracts (a market-consistent basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given in the section entitled Options and guarantees on page 110.

The realistic excess capital is calculated as the difference between realistic assets and realistic liabilities of the With Profit Fund with a further deduction to cover various stress tests (the Risk Capital Margin). In circumstances where the realistic excess capital position is less than the statutory excess capital , the company is required to hold additional capital to cover the shortfall. Any



additional capital requirement under this test is referred to as the With Profit Insurance Capital Component.

The determination of realistic liabilities of the With Profit Funds includes the value of internal transfers expected to be made from each With Profit Fund to the Non Profit Fund held within the same life insurance entity. These internal transfers may include charges on policies where the associated costs are borne by the Non Profit Fund. The With Profit Insurance Capital Component may be reduced by the value, calculated in the stress test scenario, of these internal transfers, but only to the extent that credit has not been taken for the value of these charges in deriving actuarial reserves for the relevant Non Profit Fund.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CAPITAL STATEMENT

The following table provides more detail regarding the capital resources available to meet regulatory capital requirements in the life insurance businesses. The figures quoted are based on management's current expectations pending completion of the annual financial returns to the FSA. The figures allow for a transfer of £150 million and an anticipated transfer of £260 million from the UK non-profit funds to the UK life shareholder funds. They also allow for a transfer of £115 million from the UK non-profit funds to the Scottish Widows With Profit Fund relating to closure under the Scottish Widows demutualisation scheme of an account in respect of unclaimed compensation payments. Within the With Profit Fund the £115 million transfer is fully offset by an increase in liabilities. An equal liability is released from the holding company of Scottish Widows plc leading to a broadly neutral impact on the Group's net assets.

## CAPITAL RESOURCES

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Funds £m	UK Life Shareholder Funds £m	Overseas Life Business £m	Total Life Business £m
<b>As at 31 December 2010 (statutory basis)</b>						
Shareholders' funds:						
Held outside the long-term funds				1,414	721	2,135
Held within the long-term funds			8,029		401	8,430
Total shareholders' funds			8,029	1,414	1,122	10,565
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	322	321				643
Value of in-force business			(6,172)		(843)	(7,015)
Other differences between IFRS and regulatory valuation of assets and liabilities			625	(919)	111	(183)
Estimated share of realistic liabilities consistent with the FSA reporting treatment	(409)	(58)				(467)
Qualifying loan capital				1,991		1,991
Support arrangement assets	344		(344)			
<b>Available capital resources</b>	<b>257</b>	<b>263</b>	<b>2,138</b>	<b>2,486</b>	<b>390</b>	<b>5,534</b>

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Funds £m	UK Life Shareholder Funds £m	Overseas Life Business £m	Total Life Business £m
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As at 31 December 2009  
(statutory basis)

Shareholders' funds:

Held outside the long-term funds				1,048	651	1,699
Held within the long-term funds			8,011		405	8,416
Total shareholders' funds			8,011	1,048	1,056	10,115
Adjustments onto a regulatory basis:						

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Unallocated surplus within insurance business	310	772				1,082
Value of in-force business			(5,513)		(793)	(6,306)
Other differences between IFRS and regulatory valuation of assets and liabilities			253	(154)	108	207
Estimated share of realistic liabilities consistent with the FSA reporting treatment	(407)	(40)				(447)
Qualifying loan capital				1,165		1,165
Support arrangement assets	354		(354)			
Available capital resources	257	732	2,397	2,059	371	5,816

Available capital resources for With-Profit Funds are presented in the table on a realistic basis as this is more onerous than on a regulatory basis.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### FORMAL INTRA-GROUP CAPITAL ARRANGEMENTS

Scottish Widows has a formal arrangement with one of its subsidiary undertakings, Scottish Widows Unit Funds Limited, whereby the subsidiary company can draw down capital from Scottish Widows to finance new business which is reinsured from the parent to its subsidiary. Scottish Widows has also provided subordinated loans to its fellow group undertaking Scottish Widows Bank plc. No such arrangement exists for Clerical Medical.

#### Constraints over available capital resources

##### SCOTTISH WIDOWS

Scottish Widows was created following the demutualisation of Scottish Widows Fund and Life Assurance Society in 2000. The terms of the demutualisation are governed by a Court-approved Scheme of Transfer (the Scheme) which, inter alia, created a With Profit Fund and a Non-Participating Fund and established protected capital support for the with-profits policyholders in existence at the date of demutualisation. Much of that capital support is held in the Non-Participating Fund and, as such, the capital held in that fund is subject to the constraints noted below.

**Requirement to maintain a Support Account:** The Scheme requires the maintenance of a Support Account within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation and must be maintained until the value of these assets reaches a minimum level. Assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the FSA permission to include the value of the Support Account (or, if greater, the excess of realistic liabilities for business written before demutualisation over the relevant assets) in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2010, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,693 million (31 December 2009: £1,627 million) and the estimated value of the Support Account was £197 million (31 December 2009: £222 million).

**Further Support Account:** The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2010, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £4,322 million (31 December 2009: £3,823 million) and the estimated combined value of the Support Account and Further Support Account was £2,446 million (31 December 2009: £2,495 million).

**Other restrictions in the Non-Participating Fund:** In addition to the policies which existed at the date of demutualisation, the With Profit Fund includes policies which have been written since that date. As a result of statements made to policyholders that investment policy will usually be the same for both types of business, there is an implicit requirement to hold additional regulatory assets in respect of the business written after demutualisation. The estimated amount required to provide such support at 31 December 2010 is £147 million (31 December 2009: £132 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year end and the new business expected to be written over the following year.

##### CLERICAL MEDICAL

The surplus held in the Clerical Medical With Profit Fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses on traditional with-profits business. The use of capital within the fund is also subject to the terms of the scheme of demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. Capital within the Clerical Medical Non Profit Fund is available to meet the With Profit Fund requirements.

##### OTHER LIFE INSURANCE BUSINESSES

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Except as described above capital held in UK Non Profit Funds is potentially transferable to other parts of the Group, subject to meeting the regulatory requirements of these businesses. There are no prior arrangements in place to allow capital to move freely between life insurance entities or other parts of the Group.

Overseas life business includes several life companies outside the UK, including Germany and Ireland. In all cases the available capital resources are subject to local regulatory requirements, and transfer to other parts of the Group is subject to additional complexity surrounding the transfer of capital from one country to another.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MOVEMENTS IN REGULATORY CAPITAL (audited)**

The movements in the Group's available capital resources in the life business can be analysed as follows:

**MOVEMENTS IN AVAILABLE CAPITAL RESOURCES**

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Funds £m	UK Life Shareholder Funds £m	Overseas Life Business £m	Total Life Business £m
As at 31 December 2009	257	732	2,397	2,059	371	5,816
Changes in estimations and in demographic assumptions used to measure life assurance liabilities	(2)	2	(40)	11	64	35
Dividends and capital transactions			(534)	377	(44)	(201)
Change in support arrangements	(10)		10			
New business and other factors	12	(471)	305	39	(1)	(116)
<b>As at 31 December 2010</b>	<b>257</b>	<b>263</b>	<b>2,138</b>	<b>2,486</b>	<b>390</b>	<b>5,534</b>

**WITH PROFITS FUNDS**

Available capital in the Scottish Widows With Profit Fund at 31 December 2010 is unchanged from 31 December 2009 at an estimated £257 million.

Available capital in the Clerical Medical With Profit Fund has decreased from £732 million at 31 December 2009 to an estimated £263 million at 31 December 2010. The fund commenced a distribution of the excess estate from 1 February 2010 by enhancing the level of future expected benefit payments

**UK NON PROFIT FUNDS**

Available capital in the UK Non Profit Funds has decreased from £2,397 million at 31 December 2009 to an estimated £2,138 million at 31 December 2010. Increases in available capital from new business were offset by changes in assumptions and proposed transfers to the UK Life Shareholder Funds. A transfer to the Scottish Widows With Profit Fund also resulted in a decrease of £115 million in available capital.

**UK LIFE SHAREHOLDER FUNDS**

Available capital in the UK Life Shareholder Funds has increased from £2,059 million at 31 December 2009 to an estimated £2,486 million at 31 December 2010. The receipt of £410 million proposed transfers from the UK Non Profit Fund and the £176 million impact of a capital restructuring exercise in the Scottish Widows Group to help mitigate the potential impacts of Basel III have been partially offset by the payment of coupons on subordinated debt and a dividend of £210 million from Scottish Widows plc to its parent company.

**OVERSEAS LIFE BUSINESS**

Available capital has increased over 2010 due to profits emerging on the in force business partially offset by new business strain.

Analysis of policyholder liabilities reported in the balance sheet in respect of the group's life insurance business is as follows. With Profit Fund liabilities are valued in accordance with FRS 27.

**ANALYSIS OF POLICYHOLDER LIABILITIES**

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	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Funds £m	Overseas Life Business £m	Total Life Business £m
<b>As at 31 December 2010</b>					
With Profit Fund liabilities	13,845	10,394	5		24,244
Unit-linked business (excluding that accounted for as non-participating investment contracts)			38,641	8,011	46,652
Other life insurance business			8,527	90	8,617
Insurance and participating investment contract liabilities	13,845	10,394	47,173	8,101	79,513
Non-participating investment contract liabilities			47,058	4,304	51,362
<b>Total policyholder liabilities</b>	<b>13,845</b>	<b>10,394</b>	<b>94,231</b>	<b>12,405</b>	<b>130,875</b>
	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Funds £m	Overseas Life Business £m	Total Life business £m
<b>As at 31 December 2009</b>					
With Profit Fund liabilities	13,347	10,225	5		23,577
Unit-linked business (excluding that accounted for as non-participating investment contracts)			32,816	6,864	39,680
Other life insurance business			11,449	183	11,632
Insurance and participating investment contract liabilities	13,347	10,225	44,270	7,047	74,889
Non-participating investment contract liabilities			45,328	1,020	46,348
Total policyholder liabilities	13,347	10,225	89,598	8,067	121,237

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **CAPITAL SENSITIVITIES (audited)**

#### **SHAREHOLDERS FUNDS**

Shareholders funds outside the long-term business fund, other than those used to match regulatory requirements, are mainly invested in assets that are less sensitive to market conditions.

#### **WITH PROFIT FUNDS**

The with-profit realistic liabilities and the available capital for the With-Profit Funds are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put options also increases the market consistent value of the options given to policyholders and worsens the capital position. Various hedging strategies are used to manage these exposures.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the With Profit Funds is partly mitigated by the actions that can be taken by management.

#### **OTHER LONG-TERM FUNDS**

Outside the With Profit Funds, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of life insurance contracts. In addition, poor cost control would gradually reduce the available capital and lead to an increase in the valuation of the liabilities (through an increased allowance for future costs).

Assets held in excess of those backing reserves are invested predominantly in cash and cash like instruments. The investment strategy is determined in line with the policy of Lloyds Banking Group to minimise both the profit volatility and the working capital (defined as available capital less minimum required capital) required to ensure all capital requirements continue to be met under a range of stress tests.

### **OPTIONS AND GUARANTEES (audited)**

The Group has sold insurance products that contain options and guarantees, both within the With Profit Funds and in other funds.

#### **OPTIONS AND GUARANTEES WITHIN THE WITH PROFIT FUNDS**

The most significant options and guarantees provided from within the With Profit Funds are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies.

For those policies written in Scottish Widows pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With Profit Fund of Scottish Widows called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2010 of £1.8 billion (2009: £1.6 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of both the Clerical Medical and Scottish Widows With Profit Funds are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.



The most significant economic assumptions included in the model are:

Risk-free yield. The risk-free yield is defined as spot yields derived from the UK gilt yield curve.

Investment volatility. The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2010, the 10 year equity-implied at-the-money assumption was set at 26.1 per cent (31 December 2009: 26.6 per cent). The assumption for property volatility was 15 per cent (31 December 2009: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 15 per cent (31 December 2009: 15 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

#### **OPTIONS AND GUARANTEES OUTSIDE THE WITH PROFIT FUNDS**

A number of typical guarantees are provided outside the With Profit Funds such as guaranteed payments on death (e.g. Term assurance) or guaranteed income for life (e.g. annuities). In addition, certain personal pension policyholders in Scottish Widows, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £57 million (31 December 2009: £64 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by some £3 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £10 million.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**INVESTMENT PORTFOLIO, MATURITIES, DEPOSITS, SHORT-TERM BORROWINGS****Trading securities and other financial assets at fair value through profit or loss; available-for-sale financial assets; held-to-maturity investments; and debt securities classified as loans and receivables**

The following table sets out the book values and valuations of the Group's debt securities, treasury and other bills and equity shares at 31 December for each of the three years indicated.

	2010 Book value £m	2010 Valuation £m	2009 Book value £m	2009 Valuation £m	2008 Book value £m	2008 Valuation £m
<b>Trading securities and other financial assets at fair value through profit or loss</b>						
US treasury and US government agencies	977	977	482	482	258	258
Other government securities	22,863	22,863	19,479	19,479	7,106	7,106
Other public sector securities	919	919	706	706	18	18
Bank and building society certificates of deposit	4,298	4,298	2,034	2,034	433	433
Mortgage-backed securities	422	422	520	520	369	369
Other asset-backed securities	2,612	2,612	2,890	2,890	1,342	1,342
Corporate and other debt securities	21,109	21,109	20,668	20,668	11,656	11,656
Treasury bills and other bills	227	227				
Equity shares	90,219	90,219	84,150	84,150	23,274	23,274
	<b>143,646</b>	<b>143,646</b>	130,929	130,929	44,456	44,456
<b>Available-for-sale financial assets</b>						
US treasury and US government agencies	5,518	5,518	2,898	2,898	358	358
Other government securities	7,034	7,034	5,771	5,771	510	510
Other public sector securities	29	29	31	31	12	12
Bank and building society certificates of deposit	407	407	1,014	1,014	9,602	9,602
Mortgage-backed securities	4,293	4,293	4,781	4,781	5,700	5,700
Other asset-backed securities	5,219	5,219	7,640	7,640	8,092	8,092
Corporate and other debt securities	12,132	12,132	19,904	19,904	2,183	2,183
Equity shares	2,255	2,255	2,031	2,031	41	41
Treasury bills and other bills	6,068	6,068	2,532	2,532	29,209	29,209
	<b>42,955</b>	<b>42,955</b>	46,602	46,602	55,707	55,707
<b>Held-to-maturity investments</b>						
US treasury and US government agencies	1,579	1,489				
Other government securities	6,326	6,227				
	<b>7,905</b>	<b>7,716</b>				
<b>Debt securities classified as loans and receivables</b>						
Mortgage-backed securities	11,650	12,293	13,322	12,799	478	402
Other asset-backed securities	12,827	13,092	17,137	15,998	540	192
Corporate and other debt securities	1,816	1,552	2,623	3,110	3,531	3,337
	<b>26,293</b>	<b>26,937</b>	33,082	31,907	4,549	3,931
Allowance for impairment losses	(558)		(430)		(133)	
	<b>25,735</b>	<b>26,937</b>	32,652	31,907	4,416	3,931



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## MATURITIES AND WEIGHTED AVERAGE YIELDS OF INTEREST-BEARING SECURITIES

The weighted average yield for each range of maturities is calculated by dividing the annualised interest income prevailing at 31 December 2010 by the book value of securities held at that date.

	Maturing within one year		Maturing after one but within five years		Maturing after five but within ten years		Maturing after ten years	
	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %
<b>Trading securities and other financial assets at fair value through profit or loss</b>								
US treasury and US government agencies	297	1.0	284	3.7	136	2.6	260	5.0
Other government securities	4,473	4.4	1,984	3.2	4,025	2.8	12,381	3.8
Other public sector securities	83	5.5	367	4.0	94	3.3	375	4.4
Bank and building society certificates of deposit	4,275	0.2	3	4.2	18	2.1	2	6.4
Mortgage-backed securities					28	5.2	394	5.2
Other asset-backed securities	138	3.1	109	6.9	230	3.7	2,135	3.5
Corporate and other debt securities	4,744	3.9	3,001	3.5	3,871	5.1	9,493	5.1
Treasury bills and other bills	227	0.7						
	14,237		5,748		8,402		25,040	
<b>Available-for-sale financial assets</b>								
US treasury and US government agencies	56		1,181	2.6	2,781	3.7	1,500	5.2
Other government securities	95		87	4.3	4,247	3.8	2,605	3.8
Other public sector securities	29	8.3						
Bank and building society certificates of deposit	375	0.6	32	0.1				
Mortgage-backed securities	404	1.3	1,861	2.1	795	1.2	1,233	1.0
Other asset-backed securities	618	0.8	3,996	0.7	381	1.0	224	2.5
Corporate and other debt securities	4,139	1.9	5,603	2.2	2,035	3.8	355	4.1
Treasury bills	6,067	0.1	1	0.3				
	11,783		12,761		10,239		5,917	
<b>Held-to-maturity investments</b>								
US treasury and US government agencies	19				874	3.0	686	4.8
Other government securities	91				5,163	3.8	1,072	3.9
	110				6,037		1,758	
<b>Debt securities classified as loans and receivables</b>								
Mortgage-backed securities	90	0.1	627	1.6	1,622	1.4	9,311	0.9
Other asset-backed securities	98	0.1	1,825	0.7	3,854	0.8	7,050	0.8
Corporate and other debt securities	648	1.3	489	1.5	132	5.4	547	0.1
	836		2,941		5,608		16,908	

The Group's investment holdings at 31 December 2010 include £31,881 million due from the UK government and its agencies and £11,293 million due from the US government and its agencies.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AS AT 31 DECEMBER 2010**

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis as at 31 December 2010.

All amounts are before deduction of impairment allowances. Demand loans are included in the maturing in one year or less category.

	Maturing in one year or less £m	Maturing after one but within five years £m	Maturing after five years £m	Total £m
<b>Domestic</b>				
Loans and advances to banks	26,228	1,459	857	28,544
Loans and advances to customers:				
Mortgages	4,858	25,747	303,926	334,531
Other personal lending	20,945	11,573	2,092	34,610
Property companies	17,875	21,608	19,680	59,163
Financial, business and other services	20,447	17,406	12,078	49,931
Transport, distribution and hotels	8,918	10,371	6,867	26,156
Manufacturing	3,933	4,336	1,330	9,599
Other	8,476	10,224	10,187	28,887
<b>Total domestic</b>	<b>111,680</b>	<b>102,724</b>	<b>357,017</b>	<b>571,421</b>
Foreign	24,043	15,728	30,070	69,841
<b>Total loans</b>	<b>135,723</b>	<b>118,452</b>	<b>387,087</b>	<b>641,262</b>
Of which:				
Fixed interest rate	30,216	29,568	106,342	166,126
Variable interest rate	105,507	88,884	280,745	475,136

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## DEPOSITS

The following tables show the details of the Group's average customer deposits in each of the past three years.

	2010 Average balance £m	2010 Average rate %	2009 Average balance £m	2009 Average rate %	2008 Average balance £m	2008 Average rate %
Non-interest bearing demand deposits	12,503		6,902		3,793	
Interest-bearing demand deposits	74,526	0.53	89,603	0.43	47,985	1.28
Savings deposits	241,145	1.67	234,273	1.19	84,756	3.60
Time deposits	39,999	2.39	33,447	3.66	18,272	6.94
<b>Total average deposits</b>	<b>368,173</b>	<b>1.46</b>	<b>364,225</b>	<b>1.21</b>	<b>154,806</b>	<b>3.19</b>

The analysis of the Group's average customer deposits for 2010 and 2009 between domestic and foreign offices is as follows:

	Domestic		Foreign		Total	
	Average balance £m	Average rate %	Average balance £m	Average rate %	Average balance £m	Average rate %
<b>2010</b>						
Non-interest bearing demand deposits	11,563		940		12,503	
Interest-bearing demand deposits	73,536	0.54	990	0.10	74,526	0.53
Savings deposits	237,629	1.67	3,516	1.71	241,145	1.67
Time deposits	34,762	2.14	5,237	4.05	39,999	2.39
<b>Total deposits</b>	<b>357,490</b>	<b>1.43</b>	<b>10,683</b>	<b>2.56</b>	<b>368,173</b>	<b>1.46</b>

	Domestic		Foreign		Total	
	Average balance £m	Average rate %	Average balance £m	Average rate %	Average balance £m	Average rate %
<b>2009</b>						
Non-interest bearing demand deposits	6,253		649		6,902	
Interest-bearing demand deposits	88,567	0.44	1,036	0.19	89,603	0.43
Savings deposits	229,234	1.19	5,039	1.33	234,273	1.19
Time deposits	31,908	3.56	1,539	5.59	33,447	3.66
<b>Total deposits</b>	<b>355,962</b>	<b>1.20</b>	<b>8,263</b>	<b>1.88</b>	<b>364,225</b>	<b>1.21</b>

## CERTIFICATES OF DEPOSIT AND OTHER TIME DEPOSITS

The following table gives details of the Group's certificates of deposit issued and other time deposits as at 31 December 2010 individually in excess of US \$100,000 (or equivalent in another currency) by time remaining to maturity.

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	3 months or less £m	Over 3 months but within 6 months £m	Over 6 months but within 12 months £m	Over 12 months £m	Total £m
<b>Domestic</b>					
Certificates of deposit	16,031	209	9,219	71	25,530
Time deposits	30,608	6,027	7,654	10,066	54,355
	46,639	6,236	16,873	10,137	79,885
<b>Foreign</b>					
Certificates of deposit and other time deposits	14,578	4,978	2,336	1,094	22,986
<b>Total</b>	61,217	11,214	19,209	11,231	102,871



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## SHORT-TERM BORROWINGS

Short-term borrowings are included within the balance sheet captions Deposits by banks, Customer accounts and Debt securities in issue and are not identified separately on the balance sheet. The short-term borrowings of the Group consist of overdrafts from banks, securities sold under agreements to repurchase, notes issued as part of lending securitisations, certificates of deposit issued, commercial paper and promissory notes issued and other marketable paper. Securities sold under agreements to repurchase, certificates of deposit issued, commercial paper, securitisation notes and covered bonds are the only significant short-term borrowings of the Group.

The following tables give details of these significant short-term borrowings of the Group for each of the past three years.

	2010 £m	2009 £m	2008 £m
<b>Liabilities in respect of securities sold under repurchase agreements</b>			
Balance at the year end	35,162	63,112	24,980
Average balance for the year	63,188	84,684	5,749
Maximum balance during the year	71,343	110,505	24,980
Average interest rate during the year	1.2%	2.0%	4.4%
Interest rate at the year end	0.6%	0.5%	3.7%
<b>Certificates of deposit issued</b>			
Balance at the year end	42,276	50,858	33,207
Average balance for the year	45,774	68,318	23,082
Maximum balance during the year	77,734	111,761	33,207
Average interest rate during the year	1.0%	1.9%	4.1%
Interest rate at the year end	0.9%	0.8%	2.2%
<b>Commercial paper</b>			
Balance at the year end	32,723	34,900	20,644
Average balance for the year	34,769	36,137	21,520
Maximum balance during the year	43,839	49,451	28,957
Average interest rate during the year	0.6%	0.8%	3.5%
Interest rate at the year end	0.5%	0.8%	0.8%
<b>Securitisation notes</b>			
Balance at the year end	40,742	37,557	10,050
Average balance for the year	42,387	43,869	10,182
Maximum balance during the year	40,742	49,766	12,707
Average interest rate during the year	1.1%	1.7%	4.1%
Interest rate at the year end	1.5%	1.4%	2.8%
<b>Covered bonds</b>			
Balance at the year end	32,150	27,311	
Average balance for the year	27,526	27,601	
Maximum balance during the year	32,150	29,408	
Average interest rate during the year	5.5%	4.4%	
Interest rate at the year end	3.8%	4.2%	

## MANAGEMENT AND EMPLOYEES

### DIRECTORS AND SENIOR MANAGEMENT

The Group is led by the board comprising executive and non-executive directors with wide experience. The appointment of directors is considered by the nomination and governance committee and approved by the board and, following the provisions in the articles of association, they must stand for election by the shareholders at the first annual general meeting following their appointment and must retire, and may stand for re-election by the shareholders, at least every three years. Independent non-executive directors are appointed for three-year renewable terms, which may, in accordance with the articles of association, be terminated without notice or payment of compensation. However, in the interests of good corporate governance and in accordance with the provisions of the UK Corporate Governance Code, effective from 2012, the board has decided that all of the directors will retire voluntarily and submit themselves for re-election at each annual general meeting, from 2011 onwards.

The board meets regularly. In 2010 the board had 17 meetings, nine of which were scheduled at the start of the year. The much larger number of meetings than anticipated reflected the challenging environment, and the need to keep the board informed of developments in a timely manner. It has a programme designed to enable the directors regularly to review corporate strategy and the operations and results of the businesses and discharge their duties within a framework of prudent and effective controls relating to the assessing and managing of risk.

The roles of the chairman, the group chief executive and the board and its governance arrangements, including the schedule of matters specifically reserved to the board for decision, are reviewed annually. The matters reserved to the board for decision include the approval of the annual report and accounts and any other financial statements; the payment of dividends; the long-term objectives of the Group; the strategies necessary to achieve these objectives; the Group's budgets and plans; significant capital expenditure items; significant investments and disposals; the basis of allocation of capital within the Group; the organisation structure of the Group; the arrangements for ensuring that the Group manages risks effectively; any significant change in accounting policies or practices; the appointment of the Company's main professional advisers and their fees; and the appointment of senior executives within the organisation and related succession planning.

According to the articles of association, the business and affairs of the Company are managed by the directors, who have delegated to management the power to make decisions on operational matters, including those relating to credit, liquidity and market risk, within an agreed framework.

All directors have access to the services of the company secretary, and independent professional advice is available to the directors at the Group's expense, where they judge it necessary to discharge their duties as directors.

As in 2009, the 2010 evaluation of the performance of the board, its committees and individual directors was facilitated externally. The review was conducted between October 2010 and February 2011 by Dr Tracy Long of Boardroom Review. Further details are provided in *Corporate governance the Board and its committees Board evaluation*.

The chairman has a private discussion at least once a year with each director on a wide range of issues affecting the Group, including any matters which the directors, individually, wish to raise.

There is an induction programme for all new directors, which is tailored to their specific requirements and includes visits to individual businesses and meetings with senior management. Major shareholders are also offered the opportunity to meet new non-executive directors. Additional regular refresher training and information sessions to address current business or emerging issues are arranged by the board.

The directors and senior management of Lloyds Banking Group plc are:

#### **SIR WINFRIED BISCHOFF ♦ ♦ +**

Chairman

Joined the board and was appointed chairman on 15 September 2009. Previously chairman of Citigroup Inc. from December 2007 to February 2009. He joined J Henry Schroder & Co in January 1966 and became managing director of Schroders Asia in 1971, group chief executive of Schroders Plc in 1984 and chairman in 1995. Following the acquisition of Schroders' investment banking business by Citigroup in 2000 became chairman of Citigroup Europe before being appointed acting chief executive officer of Citigroup in 2007 and subsequently as chairman in the same year. A non-executive director of Eli Lilly and Company, and The McGraw Hill Companies Inc. in the United States. A member of the Akbank International Advisory Board, Chairman of the Advisory

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Council of TheCityUK, and a member of the National Advisory Board of the UK Career Academy Foundation. Aged 70.

### **LORD LEITCH\*◆**

Deputy Chairman and Independent Director

Joined the board in 2005 and was appointed deputy chairman in May 2009. Appointed chairman of Scottish Widows in 2007. Held a number of senior and general management appointments in Allied Dunbar, Eagle Star and Threadneedle Asset Management before the merger of Zurich Group and British American Tobacco's financial services businesses in 1998. Subsequently served as chairman and chief executive officer of Zurich Financial Services United Kingdom, Ireland, Southern Africa and Asia Pacific, until his retirement in 2004. Chairman of the Government's Review of Skills (published in December 2006) and deputy chairman of the Commonwealth Education Fund. Chairman of BUPA, Intrinsic Financial Services, and Chairman of Medical Aid Films. Chancellor of Carnegie College and a non-executive director of Paternoster. Former chairman of the National Employment Panel. Aged 63.

### **ANITA M FREW\*+**

Independent Director

Joined the board on 1 December 2010. Chairman of Victrex, the FTSE 250 global manufacturer of high performance polymers, having previously been the Senior Independent Director. Since 2000, she has held a portfolio of Non-Executive Directorships, currently holding positions as Senior Non-Executive Director of Aberdeen Asset Management and as Non-Executive Director of IMI. Prior to this she was Executive Director of Abbott Mead Vickers, Director of Corporate Development at WPP Group, and has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland. Aged 53.

## MANAGEMENT AND EMPLOYEES

### **SIR JULIAN HORN-SMITH**◆ +

Independent Director

Joined the board in 2005. Held a number of senior and general management appointments in Vodafone from 1984 to 2006 including a directorship of that company from 1996, group chief operating officer from 2001 and deputy chief executive officer from 2005. Previously held positions in Philips from 1978 to 1982 and Mars GB from 1982 to 1984. A non-executive director of De La Rue, Digicel Group and Emobile (Japan), a director of Sky Malta, a member of the Altimo International advisory board and a senior advisor to UBS and CVC Capital Partners in relation to the global telecommunications sector. Deputy Chairman of Vallar plc. Pro vice-chancellor of University of Bath. A former chairman of The Sage Group. Aged 62.

### **GLEN R MORENO**◆ ++

Senior Independent Director

Joined the board on 1 March 2010. Chairman of Pearson, the media group, since October 2005. A non-executive director of Fidelity International, one of the world's largest fund management companies, and chairman of its audit committee. Deputy chairman of the Financial Reporting Council. From 1987 to 1991 he was chief executive of Fidelity International. Until mid 2009, he was a non-executive director and senior independent director of Man Group, the FTSE 100 financial services group, and acting chairman of UKFI. Former group executive at Citigroup; from 1969 to 1987 he held a number of senior positions at the bank in Europe and Asia. Aged 67.

### **DAVID L ROBERTS**\* +

Independent Director

Joined the board on 1 March 2010. Executive director, member of the group executive committee and chief executive, International Retail and Commercial Banking at Barclays until December 2006. Joined Barclays in 1983 and held various senior management positions, including chief executive, Personal Financial Services and chief executive, Business Banking. Was also a non-executive director of BAA until June 2006 and a non-executive director of Absa Group Limited, one of South Africa's largest financial services groups, until October 2006. From 2007 to 2009 he was also the chairman and chief executive of BAWAG P.S.K. AG, the second largest retail bank in Austria. Non-executive chairman of The Mind Gym and a non-executive director of Campion Willcocks. Aged 48.

### **T TIMOTHY RYAN, JR**\* +

Independent Director

Joined the board in March 2009. President and chief executive of the Securities Industry and Financial Markets Association. Held a number of senior appointments in JP Morgan Chase from 1993 to 2008 including vice chairman, financial institutions and governments, from 2005. A director of the US-Japan Foundation, Great-West Life Annuity Insurance Co., Power Corporation of Canada and Power Financial Corporation and Putnam Investments and a member of the Global Markets Advisory Committee for the National Intelligence Council. A former director in the Office of Thrift Supervision, US Department of the Treasury and Koram Bank and the International Foundation of Election Systems. Aged 65.

### **MARTIN A SCICLUNA**◆\*\*+

Independent Director

Joined the board in September 2008. Chairman of Deloitte UK from 1995 to 2007 and a member of the board from 1991 to 2007. Joined the firm in 1973 and was a partner from 1982 until he retired in 2008. A member of the board of directors of Deloitte Touche Tohmatsu from 1999 to 2007. Chairman of Great Portland Estates. A member of the council of Leeds University and a governor of Berkhamsted School. Aged 60.

### **ANTHONY WATSON CBE**◆\*

Independent Director

Joined the board in April 2009. Previously chief executive of Hermes Pensions Management. Held a number of senior appointments in AMP Asset Management from 1991 to 1998. A non-executive director of Hammerson, Vodafone and Witan Investment Trust, a member of the Norges Bank Investment Management advisory board and chairman of Marks and Spencer Pension Trust and Lincoln's Inn investment committee. A former chairman of MEPC, the Asian Infrastructure Fund and of the Strategic Investment Board (Northern Ireland) and a former member of the Financial Reporting Council. Aged 66.

**ANTÓNIO HORTA-OSÓRIO**

Group Chief Executive

Joined the board on 17 January 2011 and became Group Chief Executive on 1 March 2011. A member of the Board and Council of the British Bankers' Association, the Advisory Council of TheCityUK and the Chartered Banker Professional Standards Board. Started career at Citibank Portugal where he was head of capital markets. At the same time, was an assistant professor at Universidade Catolica Portuguesa. Then worked for Goldman Sachs in New York and London. In 1993, joined Grupo Santander as Chief Executive of Banco Santander de Negocios Portugal and then became Chief Executive Officer of Banco Santander Brazil. In 2000, became Chief Executive Officer of Santander Totta, and Chairman from 2006 until 2011, as well as Executive Vice President of Grupo Santander and a member of its Management Committee. He joined Santander UK, as a Non-Executive Director in November 2004 and from August 2006 until November 2010, was its Chief Executive. Former Non-Executive Director of the Court of the Bank of England. Aged 47.

**ARCHIE G KANE**

Group Executive Director Insurance (Board Representative for Scotland)

Joined the Group in 1986 and held a number of senior and general management appointments before being appointed to the board in 2000, as group executive director, IT and operations. Has announced his intention to retire and will not be seeking re-election at the 2011 AGM. Appointed group executive director, insurance and investments in October 2003. After some 10 years in the accountancy profession, joined General Telephone & Electronics Corporation in 1980, serving as finance director in the UK from 1983 to 1985. Association of British Insurers (ABI) Board member (and former ABI Chairman 2007-10). Member of Advisory Council of TheCityUK and Scottish Government's Financial Services Advisory Board. Aged 58.

## MANAGEMENT AND EMPLOYEES

### G TRUETT TATE

Group Executive Director Wholesale

Joined the Group in 2003 as managing director, corporate banking before being appointed to the board in 2004. Served with Citigroup from 1972 to 1999, where he held a number of senior and general management appointments in the USA, South America, Asia and Europe. He was president and chief executive officer of eCharge Corporation from 1999 to 2001 and co-founder and vice chairman of the board of Chase Cost Management Inc from 1996 to 2003. A non-executive director of BritishAmerican Business Inc. and AFME. Chairman of Arora Holdings and a director of Business in the Community and a director and trustee of In Kind Direct. Aged 60.

### TIM J W TOOKEY

Group Finance Director

Joined the Group in 2006 as deputy group finance director, before being appointed acting group finance director in April 2008. Appointed to the board in October 2008 as group finance director. Previously finance director for the UK and Europe at Prudential from 2002 to 2006 and group finance director of Heath Lambert Group from 1996 to 2002. Prior to that, he spent 11 years at KPMG. A non-executive director of the British Bankers Association and chairman of its audit committee and remuneration committee. Fellow of the Institute of Chartered Accountants in England and Wales. Aged 48.

### HELEN A WEIR CBE

Group Executive Director Retail

Joined the board in 2004 as group finance director. Has announced her intention to leave the Group and will not be seeking re-election at the 2011 AGM. Appointed as group executive director, UK retail banking in April 2008. Group finance director of Kingfisher from 2000 to 2004. Previously finance director of B&Q, having joined that company in 1995 from McKinsey & Co where she was a senior manager. Began her career at Unilever. Member of the Financial Services Practitioner Panel and the Said Business School Advisory Council. Chair of the British Bankers Association Retail Committee and a member and trustee of IFS School of Finance. A former member of the Accounting Standards Board. Fellow of the Chartered Institute of Management Accountants. Aged 48.

\*Member of the audit committee \*\*Chairman of the audit committee ♦ Member of the nomination & governance committee ♦ ♦ Chairman of the nomination & governance committee Member of the remuneration committee Chairman of the remuneration committee +Member of the risk committee ++ Chairman of the risk committee

## EMPLOYEES

As at 31 December 2010, the Group employed 104,230 people (on a full-time equivalent basis), compared with 107,144 at 31 December 2009. At 31 December 2010 100,593 employees were located in the UK, 1,830 in continental Europe, 530 in the Americas, and 1,277 in the rest of the world. At the same date, 52,930 people were employed in Retail, 16,657 in Wholesale, 7,798 in Wealth and International, 8,884 in Insurance, 15,575 in Group Operations, and 2,386 in other functions.

The Group is committed to providing employment practices and policies which recognise the diversity of its workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief.

In the UK, the Group belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers Forum on Disability, Employers Forum on Age, Stonewall and the Race for Opportunity. The Group's involvement with these organisations enables it to identify and implement best practice for its staff.

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

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Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in the Group. Further details are given in *Compensation*.

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

The Group has a code of business conduct which applies to all employees. The code as amended from time to time is available to the public on the Company's website at [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

### **MEETINGS WITH SHAREHOLDERS**

In order to develop an understanding of the views of major shareholders, the board receives regular reports from the group finance director and the director of investor relations.

The chairman, the group chief executive and the group finance director also have meetings with representatives of major shareholders and the senior independent director also attends some of these meetings. In addition, all directors are invited to attend investment analysts' and stockbrokers' briefings on the financial results.

All shareholders are encouraged to attend and participate in the Group's annual general meeting.

## COMPENSATION

This is a report made by the board of Lloyds Banking Group plc, on the recommendation of the remuneration committee. It covers the current and proposed components of the remuneration policy and details the remuneration for each serving director during 2010.

## GOVERNANCE AND RISK MANAGEMENT

An essential component of our approach to remuneration is the governance process that underpins it. This ensures that the Group's policy is robustly applied and risk is managed appropriately.

The overarching purpose of the Remuneration Committee is to consider, agree and recommend to the board an overall remuneration policy and philosophy for the Group that is aligned to its long-term business strategy, business objectives, risk appetite and values and recognises the interests of relevant stakeholders. The Group has a conservative business model characterised by a risk culture founded on prudence and accountability. The remuneration policy and philosophy covers the whole Group, but the Committee pays particular attention to the top management population, including the highest paid employees in each division, those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group's risk profile. The Committee's role is to ensure that these colleagues are provided with appropriate incentives and reward to encourage them to enhance the performance of the Group and that they are recognised for their individual contribution to the success of the organisation, whilst ensuring that there is no reward for excessive risk taking.

The Committee determines the pensions policy for the Group and advises on other major changes to employee benefits schemes. It also agrees the policy for authorising claims for expenses from the Group Chief Executive and the Chairman. It has delegated power for settling remuneration for the Chairman, the Group Executive Directors, the Company Secretary and any group employee whose salary and bonus exceeds a specified amount, currently £750,000. To ensure compliance with the FSA Code of Practice, the Committee approves remuneration for remuneration Code Staff and that of senior risk and compliance officers.

The Committee monitors the application of the authority delegated to the Group Executive Committee and the divisional Remuneration Committees to ensure that policies and principles are being fairly and consistently applied. The Committee liaises closely with the Risk Committee and the risk function in relation to risk-adjusted performance measures, including consideration of both current and future risk. Together the management of remuneration and risk form an integral part of the Board's determination of Group corporate strategy.

All the independent Non-Executive Directors are invited to attend meetings and have the opportunity to comment on proposals and have their views taken into account before the Committee's decisions are implemented.

The Committee's terms of reference are available from the Company Secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com). These terms were updated in January 2011 to ensure continued compliance with the FSA Code.

The members of the Committee during 2010 were as follows:

Dr Wolfgang Berndt (chairman to 6 May 2010)

Anthony Watson (chairman from 6 May 2010)

Sir Winfried Bischoff

Sir Julian Horn-Smith

Lord Leitch

Glen Moreno (from 1 March 2010 to 17 June 2010)

David Roberts (from 1 March 2010)

Tim Ryan (from 1 March 2010)

During 2010, the Committee met 15 times and considered the following principal matters:



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Review of remuneration arrangements for senior executives. Upon the appointment of the new Group Chief Executive we have deferred the implementation of this work until the completion of the strategy review and will consult shareholders during 2011

Determination of the appropriate remuneration packages for the new Group Chief Executive and a number of other senior new hires

Determination of bonus pools based on Group performance and risk adjustments

Performance conditions for the Long Term Incentive Plan

Bonus and salary awards for Executive Directors and key senior managers

Approval of remuneration and terms of service that fall within the Committee's terms of reference, including new executive appointments

Feedback from the Remuneration Committee Chairman on his meetings with the FSA and shareholders

We thank all committee members for their commitment during the last year and attendance at meetings.

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. During the year, the Committee conducted a review of their independent advisors and appointed Deloitte LLP to advise the Committee. Deloitte has voluntarily signed up to the Remuneration Consultants' Code of Conduct and are judged by the Committee to be independent. Kepler Associates were also retained by the Committee during 2010 to advise on various matters relating to executive remuneration.

During 2010, Alithos Limited continued to provide information on behalf of the Committee for the testing of TSR performance conditions for the Group's long-term incentive plans (calculated by reference to both dividends and growth in share price).

Eric Daniels, Angie Risley (Group HR Director), Liz Jackson (HR Director, Reward from March 2010) and Harriet Kemp (HR Director, Total Reward until March 2010) provided guidance to the Committee (other than for their own remuneration). Carol Sergeant (Chief Risk Officer) and Tim Tookey (Group Finance Director) also attended the Committee to advise as and when necessary on risk and financial matters.

## COMPENSATION

### DIRECTORS REMUNERATION POLICY

Following review in 2010, the Group's remuneration policy continues to support our business values and strategy, based on building long-term relationships with our customers and employees and managing the financial consequences of our business decisions across the entire economic cycle.

The Group's policy is intended to ensure that its remuneration offer is both cost effective and enables it to attract and retain Executive Directors and senior management of the highest calibre, motivating them to perform to the highest standards.

The Group's objective is to align individual reward with its performance, the interests of its shareholders, and a prudent approach to risk management. In this way the Group balances the requirements of its various stakeholders: its customers, shareholders, employees, and regulators. This approach is in line with the Association of British Insurers best practice code on remuneration and the FSA Remuneration Code of Practice, as the policy seeks to reward long-term value creation whilst not encouraging excessive risk taking.

The table below summarises how each of these policy objectives is met by the Group's remuneration offer.

Policy objective	How achieved
Building long-term relationships	<p>The Group builds relationships with its customers and people. Working for Lloyds Banking Group is about more than pay. The Group's relationship with its people means that it wants to pay them fairly and competitively, but its pay is positioned conservatively against the market and it does not seek to align with the highest payers in the sector. In setting pay for Executive Directors and senior managers, the Group takes account of relative pay positioning and target levels of variable remuneration opportunity for all levels of employees in the Group.</p> <p>The Group's incentive measures are not just financial. Its Balanced scorecards include objectives that cover effective risk management, lending to Corporates including SMEs and retail customers, performance against targets that measure how satisfied its customers are and the extent to which its employees feel engaged with and committed to working for the Lloyds Banking Group.</p>
Managing the financial consequences of our business through the economic cycle	<p>Economic profit is a key measure by which the Group manages its business. This measure takes into account the level of capital required to generate profits as well as the risks taken. The same level of profit generated at lower risk results in higher economic profit. Economic profit also measures risk based on an assessment of how the business will perform through the economic cycle.</p> <p>For example, in good times, when default rates on loans are low, the Group adjusts the economic profit measure downwards based on a higher average expected default experience over the economic cycle. This encourages the Group to avoid business and funding strategies that are only profitable during boom times but turn bad in a recession. Economic profit plays a prominent role in the Group's incentive plans for executives, with its inclusion in both the annual and LTIP performance measures.</p>
Aligning individual rewards with Group performance and shareholders	<p>The Group's executives' annual and long-term incentives are based on stretching performance objectives and targets in the Group Balanced Scorecard. This balanced scorecard is derived from the Medium Term Plan which defines the financial and non-financial targets within the Group's agreed risk appetite over a three year period.</p> <p>The annual bonus for Executive Directors is deferred into shares and released over a period of not less than two years, helping to increase alignment with shareholders. These deferrals are subject to malus in the event of unsustainable performance.</p>

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Executives are also aligned with shareholders through the LTIP, which pays out in shares to improve alignment with shareholders based on performance against Group financial targets over a three year period.

The Group operates tough contract provisions relative to market practice, whereby no executive has an entitlement to more than 12 months' notice (not taking into account recruitment provisions), and pay in lieu of notice is limited to basic salary, is paid monthly over 12 months and is mitigated if the executive gets another job. This approach avoids the risk of payment for failure. These requirements are among the toughest in the FTSE 100.

A prudent approach to risk management

Economic profit measures profit relative to the risk taken to generate that profit. Its use in the Group's incentive plans encourages executives to take a prudent approach to risk.

The Group also has non-financial measures of performance against risk objectives in both the annual and long-term plans for executives.

For the 2010 annual incentive plan the Group increased the alignment to long-term prudent risk management by deferring 100 per cent of the award subject to malus over two years. If the performance is unsustainable during the deferral period some or all of the award may be forfeited.

The Group has a robust governance framework with an independent Remuneration Committee reviewing all compensation decisions for senior executives. This approach to governance and review is cascaded through the organisation. The Group also ensures that all control function employees are assessed and their remuneration determined jointly by the relevant business Director and the control function Director. Senior risk and compliance officers are also reviewed by the Remuneration Committee.

Cost effective packages to attract and retain executives

The Group aims to ensure that the totality of remuneration for executive directors is competitive against our benchmark groups. These groups are other major UK banks and the top 20 companies in the FTSE 100, reflecting practices in large UK companies across all sectors. The Group aims to be competitively but conservatively positioned against the market, although for executive directors the Group has taken the decision to adopt a position that is behind market for 2011 in view of public concern.

The Group selects incentive plan targets that are directly linked to the business strategy and priorities, ensuring alignment with company performance, targets that are meaningful to executives and incentive packages that are valued by executives and cost effective.

## COMPENSATION

## SUMMARY

Following extensive consultation with shareholders, the Remuneration Committee is proposing a package for Executive Directors for 2011 that is closely based on the structure and principles of 2010 as follows:

Element	Level/design for 2011	Key purpose
Base salary	<p>Base pay should be set relative to FTSE 20 and banking sector competitors</p> <p>In light of circumstances, there will be increases to base salaries in line with the wider population of employees resulting in a lower quartile position</p>	<p>To provide the basis for a competitive package</p>
Annual incentive	<p>200 per cent of salary maximum (225 per cent for the Group Chief Executive)</p> <p>Based on Group financial targets relating to profit before tax and economic profit as well as balanced scorecard measures covering divisional financial targets, customers (e.g. SME lending), people, risk and building the business</p> <p>Subject to deferral and malus in line with FSA requirements</p>	<p>Alignment with Group performance Motivation of executives Pay for performance Alignment with sound risk management</p>
Long-term incentive plan	<p>Annual awards of up to 300 per cent of salary vesting based on financial measures including Economic Profit and EPS and alignment with shareholders based on absolute TSR</p> <p>A higher award will be made to António Horta-Osório as detailed in <i>Compensation Directors remuneration policy Group Chief Executive transition</i></p>	<p>Motivation and retention of executives Alignment with sound risk management Alignment with long-term shareholder interests</p>
Pension	<p>Defined contribution pension provision for new entrants</p> <p>From April 2012, any executive director in office at that time with a legacy final salary pension will move to a defined contribution pension arrangement</p>	<p>Enable executives to build long-term retirement savings Retention</p>

## COMPENSATION

### GROUP CHIEF EXECUTIVE TRANSITION

#### Eric Daniels

On 20 September 2010, Eric Daniels announced his intention to retire from Lloyds Banking Group on 30 September 2011. Mr Daniels stood down from the Board on 28 February 2011.

He will continue to receive his basic salary, pension contribution and other benefits under the terms of his contract until retirement. 100 per cent of his bonus received in respect of 2010 will be deferred into shares in two equal tranches, vesting in March 2013 and March 2014 and subject in part to a holding period on vesting.

His outstanding long-term incentive awards will continue to vest at the end of the relevant three year performance period to the extent the performance conditions have been met and will be pro-rated for service.

#### António Horta-Osório

António Horta-Osório was appointed to the Board on 17 January 2011 and succeeded Eric Daniels as Group Chief Executive on 1 March 2011. In line with the Group's prudent remuneration policy and the current operating environment, his salary was set on recruitment at the same level as the outgoing Group Chief Executive's at £1,035,000. Recognising that this is behind the market, the committee decided to award an increase in line with the other Executive Directors, effective from his start date. He also has a reference salary of £1,220,000 that will be used to calculate certain elements of long-term remuneration, including his LTIP from 2012 and pension.

He will participate in the Group's annual incentive scheme for the calendar year 2011. His annual bonus maximum opportunity for 2011 will be 225 per cent of basic salary. This will be subject to deferral on terms at a minimum in line with the FSA Code and the deferred element will be subject to malus if the performance that generated the incentive is found to be unsustainable.

The Group agreed, as a condition of his accepting the appointment of Group Chief Executive on 1 March 2011, to grant him an LTIP award over the Group's shares with a market value equal to 420 per cent of his base salary as at 7 March 2011.

His award will be made under Listing Rule 9.4(2) of the Listing Rules in order to facilitate his appointment as Group Chief Executive. The Board considered that it was essential to the success of the recruitment process to make this LTIP award to him. The award is on similar terms to awards granted under the LTIP including the performance conditions which will apply to LTIP awards granted in 2011 described on page 124.

He will be eligible for a pension allowance in respect of future service of 50 per cent of reference salary per annum including his flexible benefit allowance. He has the option to take this as a cash allowance or contribution to a pension scheme/vehicle. He has been granted a number of one-off awards to compensate him for outstanding share and cash awards forfeited on his resignation from the Santander Group. These include:

Performance shares of 1,707,763 due to vest in 2013 subject to the Group's TSR performance against sector peer group, broadly equivalent to the performance conditions of Santander Group;

Restricted shares of 4,348,029 due to vest between 2011–2013 subject to remaining in employment; and

Cash amounting to £516,000 vesting in three equal tranches in 2011–2013.

The awards above vest in different proportions at different times to reflect the vesting periods of the Santander Group share awards which the awards replace. On his resignation from Banco Santander, he suffered significant loss in relation to his previous pension accrual. Lloyds Banking Group will compensate him in part for the loss of this income through the provision of an unfunded unapproved retirement benefit scheme (UURBS) up to a maximum of 26.5 per cent of base salary. If he achieves the performance conditions described below at the maximum level, the pension accrued would still only represent 60 per cent of the pension forfeited by him. This pension is payable from retirement at age 65.

In order to fully promote alignment with shareholders, this pension provision will accrue over the first six years of service and is entirely dependent on the achievement of share price targets as follows:

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At retirement, a percentage of reference salary (or basic salary if higher) for each of the first five calendar years of employment if in the last 90 days of that year the average share price of Lloyds Banking Group exceeds 75p ( Average Share Price ). The percentage applicable is 4 per cent in year 1, 3.5 per cent in year 2 and 3 per cent in years 3, 4 and 5.

Plus an additional 2 per cent for each year if the Average Share Price exceeds:

Year 1: 90p

Year 2: 102p

Years 3-5 inclusive: 114p

If at the end of the fifth year of employment the aggregate percentage pension accrued is less than 26.5 per cent, he may accrue up to a further 4.5 per cent in the sixth year (to an overall maximum of 26.5 per cent of base salary) if the Average Share Price for that year exceeds 75p and up to a further 2 per cent if the Average Share Price for that year exceeds 114p.

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## COMPENSATION

### BASE SALARY

Base salaries are reviewed annually, taking into account individual performance and market information (which is provided by Towers Watson and supplemented with information from Deloitte LLP) and normally adjusted from 1 January of the relevant year. The remuneration committee confirmed during the 2010 review that the FTSE 20 was the most appropriate comparator group to use to benchmark overall competitiveness of the remuneration package whilst taking particular account of the remuneration practice of our direct competitors, namely the major UK banks.

Our review showed that salary levels are significantly below market. However, we have continued to show restraint and made a moderate increase to base salaries in 2011, in line with the salary increase budget for other employees in the Group.

Name	J E Daniels	António Horta-Osório	A G Kane	G T Tate	T J W Tookey	H A Weir
As at 1 January 2011	£1,035,000	£1,061,000 <sup>1</sup>	£601,800	£656,000	£615,000	£641,000
As at 1 January 2010	£1,035,000		£590,000	£640,000	£600,000	£625,000

<sup>1</sup> With effect from 17 January 2011

On 9 March 2011, the Group announced that neither A G Kane nor H A Weir would seek re-election as a director at the Group's Annual General Meeting on 18 May 2011. Mr Kane will retire from the Group on a date that will be communicated in due course. Mrs Weir will leave the Group on a date that will be communicated in due course. Accordingly, the salary increases and Long Term Incentive Awards to Mr Kane and Mrs Weir shown in this document have not been made.

### ANNUAL INCENTIVE PLAN

The annual incentive scheme for Executive Directors is designed to reflect specific goals linked to the performance of the business.

Incentive awards for Executive Directors are based upon individual contribution and overall corporate results. Incentive opportunity is driven by corporate performance based on profit before tax and economic profit, together with divisional achievement and individual performance. Individual targets relevant to improving overall business performance are contained in a balanced scorecard and are grouped under the following headings:

Financial

Building the Business

Customer service

Risk

People development

These targets are weighted differently for each of the Executive Directors, reflecting differing strategic priorities. The non-financial measures include key performance indicators relating to risk management, SME lending, process efficiency, service quality and employee engagement.

The remuneration committee believes that the structure of the incentive – in particular the use of risk-adjusted and non-financial measures – has been highly successful in promoting a long-term focus within the senior management team.

The maximum annual incentive opportunity is 200 per cent (225 per cent for the Group Chief Executive) of basic salary for the achievement of exceptional performance targets.

Consistent with the aim of ensuring that short-term financial results are only rewarded if they promote sustainable growth, the 2010 annual incentive is subject to deferral in shares until at least March 2013. This deferred amount is subject to malus if the

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performance that generated the incentive is found to be unsustainable.

The committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if they deem this appropriate.

The calculation of the annual incentive plan outcomes for Executive Directors, based on the achievement of performance against targets in respect of performance in 2010, has been vigorously discussed by the Remuneration Committee. The bonuses awarded to directors are shown in the table below:

Name	J E Daniels	A G Kane	G T Tate	T J W Tookey	H A Weir
Maximum Opportunity	225%	200%	200%	200%	200%
% awarded for 2010	140%	130%	164%	157%	140%
Bonus awarded for 2010	£1,450,000	£767,000	£1,050,000	£942,000	£875,000



## COMPENSATION

### LONG-TERM INCENTIVE AWARD

The current LTIP rules allow for awards to be made of up to 400 per cent of base salary. Under normal circumstances, awards can be made of up to 300 per cent of salary with the additional 100 per cent available for circumstances that the Remuneration Committee deems to be exceptional. In 2010, awards were made of up to 275 per cent of base salary to the executive directors. In 2011, the committee intends to make awards of 300 per cent of salary. As noted, for António Horta-Osório his award for 2011 will be 420 per cent of his base salary.

### LONG-TERM INCENTIVE PERFORMANCE MEASURES

During the 2010 review, the Committee was particularly mindful of driving sustainable performance through the cycle without encouraging excessive risk taking. The Committee has consulted widely with shareholders on the topic of performance measures and sharing the growth in the Company appropriately between shareholders and management. The Committee believes that the performance measures for the 2011 LTIP award for the Executive Committee should be Economic Profit (EP), Earnings per share (EPS) and absolute Total Shareholder Return. These measures capture risk measurement, profit growth and shareholder experience and align shareholder experience and management reward.

At this time the Committee is not in a position to determine the metrics that will attach to these performance measures as the new Group Chief Executive is completing a strategic review of the business. We believe it is critical to ensure that the 2011 LTIP is aligned with the new strategic direction of the Company and the goals we will set for ourselves over the medium term. Therefore the Committee intends to determine the appropriately stretching and challenging metrics following the completion of the strategic review and to consult with shareholders on the metrics during the summer prior to communicating them to participants. The Committee recognise this is an unusual approach but given the circumstances believe it is the best way to align management reward and the strategy over the next three years.

The metrics set by the Committee following the strategic review and consultation with major shareholders will be put to the annual general meeting in 2012 for approval.

Details of current LTIP awards are provided on page 132.

### PENSION

Executive directors are entitled to participate in the Group's defined contribution scheme (under which their pension entitlement will be based upon both employer and employee contributions). Company contributions are 25 per cent of salary, with the exception of António Horta-Osório who is eligible for 50 per cent of reference salary, including his flexible benefit allowance. These can be taken as cash or pension contributions.

At the date of this report, two executive directors remain in a defined benefit scheme. Pension accruals under the defined benefits scheme for Eric Daniels and Archie Kane will continue until the date of retirement or April 2012 whichever is earlier. Thereafter Archie Kane will have the opportunity to either participate in a defined contribution scheme or to receive a cash supplement with no compensation for ceasing final salary accrual. There is no entitlement to an immediate and unreduced pension should their employment be terminated before the normal date of retirement. The defined benefit schemes are closed to new entrants.

Details of pension contributions and accruals are shown on page 128.

### OTHER SHARE PLANS

The executive directors are also eligible to participate in the Group's sharesave and share incentive plans. These are all-employee share plans.

### SHAREHOLDING GUIDELINES

Executives are required to build up a holding in Lloyds Banking Group shares of value equal to 1.5 times gross salary (2 times gross salary for the Group Chief Executive). They are expected to retain 100 per cent of the net-of-tax proceeds of the 2009 LTIP until they reach this target. In addition they are required to retain any shares vesting from the share price performance element of the 2010 LTIP for a further two years post vesting.

**CHAIRMAN S REMUNERATION**

The Chairman s remuneration comprises salary and benefits. He does not participate in the annual bonus and long-term incentive arrangements, nor is he entitled to pension benefits.

The Chairman s salary was reviewed as part of the remuneration review in 2010. The review took into account market information and also the significant amount of time the chairman would be expected to focus on the Group s activities particularly during the current period. Following this review, it was determined to maintain the chairman s salary at £700,000 per annum.

## COMPENSATION

## INDEPENDENT NON-EXECUTIVE DIRECTORS FEES

The fees of the Independent Non-Executive Directors are agreed by the Board within a total amount determined by the shareholders. Non-Executive Directors may also receive fees, agreed by the Board, for membership of Board Committees. The fees are designed to recognise the various responsibilities of a Non-Executive Director's role and to attract individuals with relevant skills, knowledge and experience. The fees are neither performance related nor pensionable and are comparable with those paid by other companies. The annual fees were reviewed in 2010 and remain unchanged as listed below.

Non-Executive Director base fee	£65,000
Senior Independent Director	£50,000
Audit Committee Chairmanship	£50,000
Audit Committee Membership	£20,000
Remuneration Committee Chairmanship	£30,000
Remuneration Committee Membership	£15,000
Risk Committee Chairmanship	£40,000
Risk Committee Membership	£15,000
Nomination & Governance Committee Membership	£5,000

In the case of the Nomination & Governance Committee, membership currently comprises the Deputy Chairman, Senior Independent Director and chairs of the Board Committees (the fees for which include membership of the Nomination & Governance Committee) and one other Independent Non-Executive Director. Only this director receives an attendance fee, which is £5,000.

Independent Non-Executive Directors who serve on the Boards of subsidiary companies may also receive fees from the subsidiaries.

## 2010 NON-EXECUTIVE DIRECTORS FEES (£)

	Board	Senior Independent Director	Audit Committee	Remuneration Committee	Nomination & Governance Committee	Risk Oversight Committee	SW Board fees <sup>1</sup>	2010 Total
W C G Berndt (until 6 May 2010)	22,698			10,726	1,497			34,921
A M Frew (from 1 December 2010)	5,417		1,667			1,250		8,334
Sir Julian Horn-Smith	65,000			15,000	5,000	15,000		100,000
Lord Leitch <sup>2</sup>	187,494		16,666	12,506			90,910	307,576
G R Moreno (from 1 March 2010)	54,167	50,000	3,333	6,667		20,000		134,167
D L Roberts (from 1 March 2010)	54,167		16,667	12,500		20,833		104,167
T T Ryan	65,000		20,000	12,500		15,000		112,500
M A Scicluna	65,000		50,000			15,000		130,000
Anthony Watson <sup>3</sup>	65,000		20,000	22,321		7,500		114,821

1 Scottish Widows Services Limited

2 Lord Leitch's composite fee of £300,000 was amended to a fee of £200,000 from 1 March plus a £60,000 fee for Scottish Widows Services Ltd. The Scottish Widows fee was increased to £120,000 from 27 April 2010. Lord Leitch stood down as Senior Independent Director on 28 February 2010.

3 Appointed Chairman of the Remuneration Committee in May 2010.

**DILUTION LIMITS**

The following charts illustrate the shares available for the Group's share plans.

## COMPENSATION

### SERVICE AGREEMENTS

The Group's policy is for Executive Directors to have service agreements with notice periods of no more than one year. All current Executive Directors are entitled to receive 12 months' notice from the Group, but would be required to give six months' notice if they wished to leave.

It is the Group's policy that where compensation on early termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured, and that bonus payments should relate to the period of actual service, rather than the full notice period, and will be determined on the basis of performance.

Any entitlements under the pension scheme or equity plans will be in accordance with the scheme rules on leaving.

	Notice to be given by the Company	Date of service agreement/letter of appointment
Sir Winfried Bischoff	6 months	27 July 2009
J E Daniels	12 months	22 January 2009
António Horta-Osório	24 months	3 November 2010
A G Kane	12 months	23 January 2009
G T Tate	12 months	9 February 2009
T J W Tookey	12 months	26 January 2009
H A Weir	12 months	21 January 2009

António Horta-Osório's initial contract will be for a two year term, diminishing to 12 months notice over the first year of employment.

Independent Non-Executive Directors do not have service agreements and their appointment may be terminated, in accordance with the articles of association, at any time without compensation.

### EXTERNAL APPOINTMENTS

The Group recognises that Executive Directors may be invited to become Non-Executive Directors of other companies and that these appointments may broaden their knowledge and experience, to the benefit of the Group. Fees are normally retained by the individual directors as the post entails personal responsibility.

Executive Directors are generally allowed to accept one Non-Executive Directorship.

During 2010, Eric Daniels received fees of £75,000 which was retained by him, for serving as Non-Executive Director of BT plc.

### PERFORMANCE GRAPH

The graph below illustrates the performance of the Group measured by TSR against a broad equity market index over the past five years. The Group has been a constituent of the FTSE 100 index throughout this five year period.

### TOTAL SHAREHOLDER RETURN FTSE 100 INDEX

## COMPENSATION

## AUDITED INFORMATION

## DIRECTORS EMOLUMENTS FOR 2010

	Salaries/ fees £000	Other benefits		Performance- related payments £000 <sup>3</sup>	2010 Total £000	2009 Total £000
		Cash £000 <sup>1</sup>	Non-cash £000 <sup>2</sup>			
<b>Current directors who served during 2010</b>						
<b>Executive Directors</b>						
J E Daniels	1,035	78	9	1,450	2,572	1,121
A G Kane	590	24	27	767	1,408	1,523
G T Tate	640	27	28	1,050	1,745	1,807
T J W Tookey	600	36	1	942	1,579	1,736
H A Weir	625	57	21	875	1,578	1,767
<b>Non-Executive Directors</b>						
Sir Winfried Bischoff	700	12			712	211
A M Frew (from 1 December 2010)	8				8	
Sir Julian Horn-Smith	100				100	100
Lord Leitch	308				308	249
G R Moreno (from 1 March 2010)	134				134	
D L Roberts (from 1 March 2010)	104				104	
T T Ryan	113				113	83
M A Scicluna	130				130	121
Anthony Watson	115				115	71
<b>Former director who served during 2010</b>						
W C G Berndt (until 6 May 2010)	35				35	100
Others						1,011
	<b>5,237</b>	<b>234</b>	<b>86</b>	<b>5,084</b>	<b>10,641</b>	<b>9,900</b>

- 1 The cash column under 'other benefits' includes flexible benefits payments (4 per cent of basic salary), the tax planning allowance for Eric Daniels, payments to certain directors who elect to take cash rather than a company car under the car scheme and a spouse's travel allowance for Truett Tate.
- 2 The non cash column includes amounts relating to the use of a company car, use of a company driver and private medical insurance. It also includes the value of any matching shares which are received under the terms of Sharematch, through which employees have the opportunity to purchase shares up to a maximum of £125 per month and receive matching shares on a one for one basis up to a maximum value of £30 per month, rounded down to the nearest whole share.
- 3 Bonuses awarded in respect of 2010 performance will be subject to 100 per cent deferral into shares until at least March 2013.

Sir Victor Blank was entitled to the use of his company car until 30 April 2010, resulting in a benefit in kind tax charge of £10,490.

**COMPENSATION  
DIRECTORS PENSIONS**
**AUDITED INFORMATION**

The Executive Directors are currently members of one of the pension schemes provided by Lloyds TSB Group with benefits either on a defined benefit or defined contribution basis. Those directors who joined Lloyds TSB Group after 1 June 1989 and are members of a defined benefit scheme have pensions provided on salary in excess of the earnings cap through membership of or by an unfunded pension promise. Retirement pensions accrue at rates of between 1/60 and 1/30 of basic salary.

For those Directors who are members of a defined benefit pension scheme, pension will continue to accrue until 5 April 2012, or the date of leaving if earlier. On 6 April 2012, defined benefit pension accrual will cease and Directors will be offered the option to participate in the defined contribution pension scheme in operation at that date. Alternatively, they may choose not to join the scheme and elect to receive a pension cash allowance.

**DEFINED CONTRIBUTION SCHEME MEMBERS**

During the year to 31 December 2010 the Group has made the following contributions to the defined contribution scheme:

	£000
G T Tate	160
T J W Tookey	150
H A Weir	125

**DEFINED BENEFIT SCHEME MEMBERS**

	Accrued pension at 31 December 2010 £000 (a)	Accrued pension at 31 December 2009 £000 (b)	Change in accrued pension £000 (a)-(b)	Transfer value at 31 December 2010 £000 (c)	Transfer value at 31 December 2009 £000 (d)	Change in transfer value £000 (c)-(d)	Additional pension earned to 31 December 2010 £000 (e)	Transfer value of the increase £000 (f)
J E Daniels	210	193	17	5,030	3,844	1,186	17	413
A G Kane	372	357	15	8,657	6,889	1,768	15	342

The disclosures in columns (a) to (d) are as required under section 421 of the Companies Act 2006.

Columns (a) and (b) represent the deferred pension to which the directors would have been entitled had they left the Group on 31 December 2010 and 2009, respectively.

Column (c) is the transfer value of the deferred pension in column (a) calculated as at 31 December 2010 based on factors supplied by the actuary of the relevant Lloyds TSB Group pension scheme.

Column (d) is the equivalent transfer value, but calculated as at 31 December 2009 on the assumption that the director left service at that date.

Column (e) is the increase in pension built up during the year, recognising (i) the accrual rate for the additional service based on the pensionable salary in force at the year end, and (ii) where appropriate the effect of pay changes in real (inflation adjusted) terms on the pension already earned at the start of the year.

Column (f) is the capital value of the pension in column (e).

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The disclosures in columns (e) and (f) are as required by the UK Listing Authority listing rules. The requirements of the listing rules differ from those of the Companies Act. The listing rules require the additional pension earned over the year to be calculated as the difference between the pension accrued at the end of the financial year and the pension accrued at the start of the financial year less the increase in the pension earned over the year solely due to inflation. The transfer value in column (f) can differ significantly from the change in transfer value as required by the Companies Act because the additional pension accrued over the year calculated in accordance with the listing rules makes allowance for inflation, and the change in the transfer value required by the Companies Act will be significantly influenced by changes in the assumptions underlying the transfer value calculation at the beginning and end of the financial year.

Members of the Lloyds TSB Group's pension schemes have the option to pay additional voluntary contributions: neither the contributions nor the resulting benefits are included in the above table.

Major changes to the legislation governing the provision of pensions in the UK (known as pension simplification) came into effect in April 2006. Benefits from an approved pension scheme will be limited to the Lifetime Allowance, currently £1.8 million which is equivalent to an annual pension of £90,000. Any benefit in excess of this amount will incur a tax charge for the individual. The Government has announced that the life time allowance will decrease to £1.5 million from April 2012. The Group has agreed that if an Executive Director has benefits in excess of the Lifetime Allowance they may cease to accrue benefits in the Scheme and receive a salary supplement as an alternative. This will not cost the Group more than the current arrangements. The Group will not compensate any individual in respect of any increased tax liability arising from pension simplification. To date, the Executive Directors affected have elected to continue to accrue benefits in the approved scheme.



COMPENSATION  
DIRECTORS INTERESTS

## AUDITED INFORMATION

The beneficial interests, of those who were directors at 31 December 2010 in ordinary shares of Lloyds Banking Group were:

## NUMBER OF SHARES

	At 1 January 2010 (or later date of appointment)	At 31 December 2010	At 24 February <sup>1</sup> 2011
<b>Executive Directors</b>			
J E Daniels	2,557,816	<b>2,560,770</b>	2,561,234
A G Kane	1,224,960	<b>1,227,914</b>	1,228,378
G T Tate	526,061	<b>529,015</b>	529,480
T J W Tookey	97,727	<b>123,891</b>	124,355
H A Weir	425,162	<b>428,116</b>	428,580
<b>Non-Executive Directors</b>			
Sir Winfried Bischoff	585,000	<b>800,000</b>	
A M Frew			
Sir Julian Horn-Smith	27,890	<b>227,890</b>	
Lord Leitch	55,787	<b>55,787</b>	
G R Moreno	200,000	<b>500,000</b>	
D L Roberts		<b>378,670</b>	
T T Ryan	75,877	<b>100,877</b>	
M A Scicluna	56,226	<b>56,226</b>	
Anthony Watson	51,357	<b>226,357</b>	

<sup>1</sup> The changes in beneficial interests between 31 December 2010 and 24 February 2011 related to partnership and matching shares acquired under the Lloyds Banking Group Share Incentive Plan.

**COMPENSATION  
INTERESTS IN SHARE OPTIONS**
**AUDITED INFORMATION**

	At 1 January 2010	Granted during the year	Exercised during the year	Lapsed during the year	Share adjustment	At 31 December 2010	Exercise price	Exercise periods		Notes
								From	To	
J E										
Daniels	131,484				<b>133,567</b>	<b>265,051</b>	207.97p	18/3/2007	17/3/2014	c, e, i
	430,547				<b>437,367</b>	<b>867,914</b>	235.26p	17/3/2008	16/3/2015	d, e, i
	6,906			<b>6,906</b>			68.95p			a, h
		<b>19,399</b>				<b>19,399</b>	46.78p	1/6/2013	30/11/2013	a, g
A G Kane	64,786			<b>64,786</b>			549.5p	6/3/2003	5/3/2010	b, f
	11,841			<b>11,841</b>			615.5p	8/8/2003	7/8/2010	b, f
	34,759				<b>35,309</b>	<b>70,068</b>	324.92p	6/3/2004	5/3/2011	b, i
	73,255				<b>74,414</b>	<b>147,669</b>	207.97p	18/3/2007	17/3/2014	c, e, i
	247,891				<b>251,818</b>	<b>499,709</b>	235.26p	17/3/2008	16/3/2015	d, e, i
	6,906			<b>6,906</b>			68.95p			a, h
		<b>19,399</b>				<b>19,399</b>	46.78p	1/6/2013	30/11/2013	a, g
G T Tate	64,400				<b>65,420</b>	<b>129,820</b>	207.97p	18/3/2007	17/3/2014	c, e, i
	27,357				<b>27,790</b>	<b>55,147</b>	199.91p	12/8/2007	11/8/2014	c, e, i
	247,891				<b>251,818</b>	<b>499,709</b>	235.26p	17/3/2008	16/3/2015	d, e, i
	6,906			<b>6,906</b>			68.95p			a, h
		<b>19,399</b>				<b>19,399</b>	46.78p	1/6/2013	30/11/2013	a, g
T J W										
Tookey	6,906			<b>6,906</b>			68.95p			a, h
		<b>19,399</b>				<b>19,399</b>	46.78p	1/6/2013	30/11/2013	a, g
H A Weir	77,868				<b>79,100</b>	<b>156,968</b>	210.70p	29/4/2007	28/4/2014	c, e, i
	247,891				<b>251,818</b>	<b>499,709</b>	235.26p	17/3/2008	16/3/2015	d, e, i
	6,906			<b>6,906</b>			68.95p			a, h
		<b>19,399</b>				<b>19,399</b>	46.78p	1/6/2013	30/11/2013	a, g

a Sharesave.

b Executive option granted between March 2000 and March 2001.

c Executive option granted between March 2004 and August 2004.

d Executive option granted from March 2005.

e Exercisable to the extent at which the performance condition vested.

f Lapsed on 10th anniversary of date of grant as the performance conditions had not been met.

g Not exercisable as the option has not been held for the period required by the relevant scheme.

h Options lapsed as sharesave contract was cancelled.

i

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Options granted under these plans were adjusted on 13 August 2010, as a result of the capital raising activities of 2009. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the capital raising events. None of the other directors at 31 December 2010 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

The market price for a share in the Company at 1 January 2010 and 31 December 2010 was 50.69p and 65.70p, respectively. The range of prices between 1 January 2010 and 31 December 2010 was 46.58p to 78.40p.

The following table contains information on the performance conditions for executive options granted since 2000. The Remuneration Committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

COMPENSATION

AUDITED INFORMATION

Options granted	Performance conditions
<p>March 2000    March 2001</p>	<p>Growth in earnings per share which is equal to the aggregate percentage change in the retail price index plus three percentage points for each complete year of the relevant period plus a further condition that the Company's ranking based on TSR over the relevant period should be in the top 50 companies of the FTSE 100.</p> <p>As the performance conditions for those options granted in March 2000 and August 2000 were not met, the options lapsed in March 2010 and August 2010 respectively.</p>
<p>March 2004    August 2004</p>	<p>That the Company's ranking based on TSR over the relevant period against a comparator group (17 UK and international financial services companies including Lloyds Banking Group) must be at least ninth, when 14 per cent of the option will be exercisable. If the Company is ranked first in the group, then 100 per cent of the option will be exercisable and if ranked tenth or below the performance condition is not met.</p> <p>Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 24 per cent for Truett Tate's March option and at 14 per cent for all other options granted to Executive Directors during 2004.</p>
<p>March 2005    August 2005</p>	<p>That the Company's ranking based on TSR over the relevant period against a comparator group (15 companies including Lloyds Banking Group) must be at least eighth, when 30 per cent of the option will be exercisable. If the Company is ranked first to fourth position in the group, then 100 per cent of the option will be exercisable and if ranked ninth or below, the performance condition is not met.</p> <p>Options granted in 2005 became exercisable as the performance condition was met when tested. Grants vested at 82.5 per cent for all options granted to Executive Directors.</p>

**LLOYDS TSB EXECUTIVE RETENTION PLAN 2006**

On 26 March 2008 (prior to his appointment as an Executive Director), Tim Tookey was granted an award under the Lloyds TSB Executive Retention Plan 2006. The award is satisfied in cash only and, subject to continued employment, gives him the right to receive an amount equal to the total value of 218,400 Lloyds Banking Group shares on the dates of vesting, as adjusted in August 2010 as a result of various corporate actions in 2009 on the same basis as the Lloyds TSB Long Term Incentive Plan. The award vests as to 50 per cent on 26 March 2011 and 50 per cent on 26 March 2013. He has agreed to reinvest the cash proceeds into Lloyds Banking Group shares. As an Executive Director, he is no longer eligible to be granted awards under this plan.

**COMPENSATION  
LLOYDS TSB LONG-TERM INCENTIVE PLAN**
**AUDITED INFORMATION**

The following table shows conditional shares awarded under the plan. Further information regarding this plan can be found on pages 133 and 134.

	At 1 January 2010	Awarded during the year	Vested during the year	Lapsed during the year	Share adjustment	At 31 December 2010	Year of vesting	Notes
J E Daniels	699,725			<b>699,725</b>			2010	
	1,098,372				<b>592,385</b>	<b>1,690,757</b>	2011	a, b
	1,496,843				<b>807,292</b>	<b>2,304,135</b>	2012	a, c
	2,245,265				<b>1,210,939</b>	<b>3,456,204</b>	2012	a, c
		<b>5,135,781</b>				<b>5,135,781</b>	2013	e
A G Kane	400,884			<b>400,884</b>			2010	
	541,252				<b>291,913</b>	<b>833,165</b>	2011	a, b
	853,273				<b>460,196</b>	<b>1,313,469</b>	2012	a, c
	1,279,909				<b>690,293</b>	<b>1,970,202</b>	2012	a, c
		<b>2,927,643</b>				<b>2,927,643</b>	2013	e
G T Tate	437,328			<b>437,328</b>			2010	
	679,186				<b>366,305</b>	<b>1,045,491</b>	2011	a, b
	925,583				<b>499,195</b>	<b>1,424,778</b>	2012	a, c
	1,388,376				<b>748,793</b>	<b>2,137,169</b>	2012	a, c
		<b>3,175,748</b>				<b>3,175,748</b>	2013	e
T J W Tookey	69,242		<b>39,339</b>	<b>73,545</b>	<b>37,344</b>		2010	d
	93,266				<b>50,301</b>	<b>143,567</b>	2011	a, b
	867,735				<b>467,995</b>	<b>1,335,730</b>	2012	a, c
	1,301,603				<b>701,994</b>	<b>2,003,597</b>	2012	a, c
		<b>2,977,264</b>				<b>2,977,264</b>	2013	e
H A Weir	419,106			<b>419,106</b>			2010	
	663,267				<b>357,720</b>	<b>1,020,987</b>	2011	a, b
	903,891				<b>487,495</b>	<b>1,391,386</b>	2012	a, c
	1,355,836				<b>731,243</b>	<b>2,087,079</b>	2012	a, c
		<b>3,101,317</b>				<b>3,101,317</b>	2013	e

- a Conditional awards of shares made under this plan prior to 2010 were adjusted on 13 August 2010 as a result of the Capitalisation Issue and Rights Issue of 2009. These adjustments were made using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.
- b Award price adjusted to 229.55p from 353.36p.
- c Award price adjusted to 35.93p from 55.31p.
- d Award vested at 31 per cent for Tim Tookey as he was not a director at the time the award was made. At vesting his award was adjusted to 106,586 from 69,242 to reflect the Capitalisation Issue and Rights Issue of 2009. The vested during the year figure includes 6,298 dividend shares accumulated prior to the stopping of dividend payments. Award price adjusted to 267.3p from 539p. The closing market price of the Group's ordinary shares on the date of release was 64.05p.

e Share price on date of award 55.42p.

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COMPENSATION

AUDITED INFORMATION

The following table contains information on the performance conditions for awards made under the long-term incentive plan. The Remuneration Committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

LTIP award	Performance conditions
March 2007	<p>For 50 per cent of the award (the EPS Award) the percentage increase in earnings per share of the Group (on a compound annualised basis) over the relevant period needed to be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the retail price index over the same period. If it was less than 3 per cent per annum, the EPS Award would lapse. If the increase was more than 3 per cent but less than 6 per cent per annum, then the proportion of shares released would be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2007 and ended on 31 December 2009.</p> <p>For the other 50 per cent of the award (the TSR Award) the Group's TSR needed to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award would vest where the Group's TSR was equal to median and vesting would occur on a straight line basis in between these points. Where the Group's TSR was below the median of the comparator group, the TSR Award would lapse. The relevant period commenced on 8 March 2007 (the date of award) and ended on 7 March 2010.</p> <p>At the end of the relevant period, neither of the performance conditions had been met and the Awards lapsed.</p> <p>Tim Tookey was not an Executive Director when his award was made in 2007, and as such his award vested at 31 per cent on the same basis as other award recipients below the Group Executive Committee level.</p>
March and April 2008	<p>For 50 per cent of the award (the EPS Award) the performance condition was as described for March 2007 with the relevant performance period commencing on 1 January 2008 and ending on 31 December 2010.</p> <p>For the other 50 per cent of the award (the TSR Award) the performance condition was as described for March 2007 with the relevant performance period commencing on 6 March 2008 (the date of the March award) and ending on 5 March 2011.</p>
April 2009	<p><b>EPS:</b> The release of 50 per cent of the shares will be dependent on the extent to which growth in EPS achieves cumulative EPS targets over the three year period from January 2009 to December 2011.</p> <p><b>Economic profit:</b> The release of the remaining 50 per cent of shares will be dependent on the extent to which the Group achieves cumulative Economic Profit targets over the three year period from January 2009 to December 2011.</p> <p>As indicated in last year's report, and as a consequence of the Group's non participation in GAPS, in June 2010 the Remuneration Committee determined that it was appropriate for the performance measures relative to those conditions to be restated:</p>

EPS

Vesting%

Growth in EPS

Threshold	25%	26%
Maximum	100%	36%

**Economic profit**

	Vesting%	Absolute improvement in adjusted EP
Threshold	25%	100%
Maximum	100%	202%

April 2009  
Integration Award

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

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

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



## COMPENSATION

## AUDITED INFORMATION

March 2010

**EPS:** Relevant to 36 per cent of the award. Performance will be measured based on absolute improvement in adjusted EPS over the three financial years starting on 1 January 2010 relative to an adjusted fully diluted 2009 EPS base.

**Economic Profit:** Relevant to 36 per cent of the award. Performance will be measured based on the compound annual growth rate of adjusted Economic Profit over the three financial years starting on 1 January 2010 relative to 2009 adjusted Economic Profit base.

**Absolute Share Price:** Relevant to 28 per cent of the award. Performance will be measured based on the Absolute Share Price on 26 March 2013, being the third anniversary of the award date.

The targets are:

**EPS**

	Vesting%	Absolute improvement in adjusted EPS
Threshold	25%	158%
Maximum	100%	180%

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

**Economic profit**

	Vesting%	Compound annual growth rate of adjusted EP
Threshold	25%	57% p.a.
Maximum	100%	77% p.a.

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

**Absolute Share Price**

	Vesting %	Absolute Share Price
Threshold	0%	75p
Maximum	100%	114p

Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element of the award may only be released if both the EPS and Economic Profit performance measures have been satisfied at the threshold level or above.

Alithos Limited provided information for the testing of the TSR performance conditions for the Company's long-term incentive plan. EPS is the Group's normalised earnings per share as shown in the Group's report and accounts, subject to such adjustments as the Remuneration Committee regards as necessary for consistency.

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None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

The register of Directors' interests, which is open to inspection, contains full particulars of Directors' shareholdings and options to acquire shares in Lloyds Banking Group.

## CORPORATE GOVERNANCE

### STATEMENT ON US CORPORATE GOVERNANCE STANDARDS

As a non-US company listed on the New York Stock Exchange (NYSE) Lloyds Banking Group plc is required to disclose any significant ways in which its corporate governance practices differ from those followed by domestic US companies listed on the NYSE. As Lloyds Banking Group plc's main listing is on the London Stock Exchange, it follows the principles contained in the combined code on corporate governance issued by the UK Financial Reporting Council (the UK Code). The Group has complied with the provisions of the UK Code and has done so throughout 2010 regarding the provisions where the requirements are of a continuing nature. Key differences are set out below.

The NYSE corporate governance listing standards require domestic US companies to adopt and disclose corporate governance policies. For Lloyds Banking Group plc, consistent with the principles of the UK Code, the nomination and governance committee sets the corporate governance principles applicable to the Company and oversees the annual evaluation of the performance of the board, its committees and its individual members.

Under the NYSE corporate governance listing standards, the remuneration, nomination and governance committees of domestic US companies must be comprised of entirely independent directors. However for Lloyds Banking Group plc, again consistent with the principles of the UK Code, the remuneration committee and the nomination & governance committee include the Chairman, with all other members being independent non-executive directors.

### DIRECTORS CONFLICTS OF INTEREST

The board, as permitted by the Company's articles of association, has authorised all potential conflicts of interest declared by individual directors. Decisions regarding these conflicts of interest could only be taken by directors who had no interest in the matter. In taking the decision, the directors acted in a way they considered, in good faith, would be most likely to promote the Company's success. The directors had the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given will be reviewed at least every 15 months. No director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest.

### THE BOARD AND ITS COMMITTEES

At the year end, the board comprised the chairman, five executive directors and eight independent non-executive directors. On 3 November 2010 the Group announced that Mr Horta-Osório would replace Mr Daniels as Group Chief Executive; this took effect on 1 March 2011. Details of Mr Horta-Osório's selection and appointment process are set out on page 122.

The board considers that it is of an appropriate size to oversee the Group's businesses, with a suitable diversity of backgrounds and mix of experience and expertise to maximise its effectiveness. The composition of the board is kept under continuous review by the chairman, with the support of the nomination and governance committee, to ensure the right balance of skills and experience. All director appointments are subject to detailed due diligence which includes a robust search and selection process overseen by the nomination & governance committee.

The chairman is responsible for leading the board and ensuring its effectiveness while the group chief executive manages the Group's business – these are distinct functions.

The chairman is responsible for the clarity and timeliness of information provided to the board and for facilitating the effective contribution of all directors and ensures that directors receive appropriate induction and ongoing training.

The chairman has a key role in the development (jointly with the group chief executive) of the Group's strategy, as well as oversight of strategy implementation and performance delivery. He ensures that there is a constructive, close working relationship with the group chief executive and the rest of the board.

### MEETINGS

Responding to the challenges faced by the Company, the board held 17 meetings during 2010. In addition there was regular contact with directors outside of these meetings. The time commitment demanded of directors, in particular, non-executive directors, was far in excess of that anticipated in the normal course of business. All directors showed themselves to be willing and able to devote the additional time required often at short notice and at unsocial hours.

## INDEPENDENCE

All the non-executive directors are considered by the board to be independent both in character and judgement and free of relationships or circumstances which could affect their judgement. Throughout the year at least half of the board comprised independent non-executive directors.

## INDUCTION AND TRAINING

All new directors and committee members receive a full and tailored induction. The primary aim of the induction programme is to provide directors with a comprehensive introduction to the Group; its individual businesses; business models; strategy; and risks. This enables directors to make an early, informed and effective contribution to board debates, based on an understanding of the key challenges facing the Group, the Group's businesses, and the business model. The induction programme is supplemented by ongoing training and development.

Early in 2010, the board reviewed and refreshed its induction programme to meet the Walker Review ( Review of corporate governance in UK banks and other financial industry entities ) recommendation of a formal, substantive and personalised induction. All directors appointed during 2010 have undertaken a three stage induction process comprising:

- a corporate induction, which provides an overview of the Group, its strategy, operational structures and main business activities;

- governance and directors' responsibilities, which explains the role and statutory duties of a non-executive director including the roles and responsibilities owed by banks and other financial services firms to the FSA and other regulatory bodies; and

- a bespoke induction plan prepared in consultation with me, tailored to the individual needs of the director, to the specific role that they will carry out, and their skills/experience to date.

The board receives regular refresher training and information sessions to address current business or emerging issues. During 2010, the non-executive directors undertook approximately five days of training, including 12 hours of structured training during board meetings. This is delivered through a

## CORPORATE GOVERNANCE

variety of means, including sessions on matters such as liquidity and funding, stress testing, living wills, the Bribery Act 2010 and special board sessions covering matters such as the Individual Capital Adequacy Assessment Process and training for Approved Persons. In addition, the Audit Committee arranged a series of deep dives to which all board members were invited, and which provided an in-depth review of the operations of each of the business divisions and of the latest accounting standards and operating methodologies. Half day sessions were delivered for each division amounting to three days in total.

### BOARD EVALUATION

The Nomination & Governance Committee recommended to the board that, as in 2009, the 2010 evaluation of the board should again be facilitated externally. Given the number of new entrants to this market, we agreed that we should explore the range of services available. Following a tender process and interviews, Dr Tracy Long of Boardroom Review was appointed to conduct the 2010 process. Boardroom Review has no other relationship with the Company.

The review was conducted between October 2010 and February 2011 through confidential interviews with all board directors and the Company Secretary, observation of a board meeting and a review of selected papers. The review was designed to be forward looking, assessing the quality of the board's decision making and debate, and its overall contribution to, and impact on, the long term health and success of the business. The review identified the strengths of the board and its committees and highlighted areas for the board to work on in order to prepare for future challenges. The board evaluation also provides feedback on the individual performance of directors which informs a general assessment which is used for individual feedback.

As Senior Independent Director, Mr Moreno leads the review of the chairman's performance with the board and provides feedback in a face-to-face meeting.

### ELECTION AND RE-ELECTION OF DIRECTORS

All directors are subject to election by shareholders at the first annual general meeting (AGM) following their appointment. Sir Winfried Bischoff, Mr Moreno and Mr Roberts were required to stand for election at the 2010 AGM, held on 6 May 2010, and were duly elected. Under the articles of association, directors are required to stand for re-election at intervals of no more than three years. At the 2010 AGM, Mr Daniels and Mrs Weir sought re-election by shareholders and were re-elected.

Ms Frew and Mr Horta-Osório were appointed to the board after the 2010 AGM and will therefore stand for election at the forthcoming AGM to be held on 18 May 2011. Under the articles of association, Sir Julian Horn-Smith and Mr Tate are required to retire from the board at the 2011 AGM. However, in the interests of good corporate governance and in accordance with provisions of the UK Corporate Governance Code, effective from 2012, the board has decided that all of the directors will retire voluntarily and submit themselves for re-election at the 2011 AGM. Mr Kane and Ms Weir have announced their intention to retire and resign from the Company respectively and will not submit themselves for re-election at the 2011 AGM.

The chairman endorsed the effectiveness and commitment of all directors standing for election or re-election at the AGM, and the senior independent director gave a similar endorsement in respect of the chairman's election.

### COMPANY SECRETARY AND INDEPENDENT ADVICE

The company secretary, Mr Baines, is responsible for advising the board on corporate governance matters and, in conjunction with the chairman, for ensuring good information flows between the board, its committees, non-executive directors and senior executives. All directors have access to his advice and services. Additionally, if required in the furtherance of their duties, non-executive directors (along with any other members of the board's main committees) are entitled to seek independent, professional advice at the Company's expense.

### RELATIONS WITH SHAREHOLDERS

The Board recognises the importance of promoting mutual understanding between the Company and its shareholders through greater engagement. In 2010, there was regular dialogue with institutional shareholders with more than 300 equity investor meetings undertaken in the year. Many of these meetings were undertaken by senior management (primarily the Group Chief Executive and Group Finance Director) or Board members. The Chairman attended a number of meetings with Shareholders to discuss governance and strategic direction. Mr Watson, as Chairman of the Remuneration Committee, regularly meets the larger shareholders to discuss executive remuneration issues while Mr Moreno, the Senior Independent Director, separately meets with a range of major shareholders.

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The Board is kept advised of the views of major shareholders by means of regular updates at Board and Committee meetings. It also receives monthly reports on market and investor sentiment and shareholder analysis.

Investor Relations has primary responsibility for managing day-to-day communications with institutional shareholders. Supported by the Group Chief Executive and Group Finance Director, they achieve this through a combination of briefings to analysts and institutional shareholders (both at results briefings and throughout the year), as well as site visits and individual discussions with institutional shareholders.

The company secretary oversees communications with private shareholders. Shareholders are encouraged to attend and participate in the Group's AGM.

### **AUDIT COMMITTEE**

The audit committee comprises Mr Scicluna (chairman), Ms Frew, Lord Leitch, Mr Roberts, Mr Ryan and Mr Watson. All members of the audit committee are independent. The committee's terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com). The board of directors has determined that Mr Scicluna is an audit committee financial expert (as defined in the rules promulgated under the U.S. Securities Exchange Act). Although Mr Scicluna has been identified as an audit committee financial expert for the purposes of the SEC's rules, the committee members are selected with a view to the expertise and experience of the committee as a whole, and the committee reports to the board of directors as a single entity. The designation of a person as an audit committee financial expert does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation. Nor does the designation of a person as an audit committee financial expert affect the duties, obligations or liability of any other member of the audit committee or board of directors.

## CORPORATE GOVERNANCE

During the year, the audit committee received reports from, and held discussions with, management and the external auditors. In discharging its duties, the committee has approved the auditors' terms of engagement, including their remuneration and, in discussion with them, has assessed their independence and objectivity (more information about which is given in note 11 to the consolidated financial statements, in relation to the procedure for approving fees for audit and non-audit work) and recommended their re-appointment at the AGM. The committee also reviewed the financial statements published in the name of the board and the quality and acceptability of the related accounting policies, practices and financial reporting disclosures; the scope of the work of the group audit department, reports from that department and the adequacy of its resources; the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations (more information about which is given in the note about internal control on page 139); the results of the external audit and its cost effectiveness; and reports from the external auditors on audit planning and their findings on accounting and internal control systems. Procedures for handling complaints regarding accounting, internal accounting controls or auditing matters and for staff to raise concerns in confidence have been established by the committee. The committee also had a meeting with the auditors, without executives present, and a meeting with the group audit director alone.

The audit committee held seven meetings during 2010, six of which were scheduled at the start of the year. In addition, the audit committee arranged six half-day deep dive meetings during 2010 which were open to and attended by other members of the board.

### CHAIRMAN'S COMMITTEE

The chairman's committee, comprising the chairman, deputy chairman, senior independent director and the group chief executive, meets to assist the chairman in ensuring the effectiveness and efficiency of board meetings. The committee exercises specific powers delegated to it by the board from time to time.

### NOMINATION & GOVERNANCE COMMITTEE

The nomination & governance committee is chaired by Sir Winfried Bischoff. Lord Leitch, Sir Julian Horn-Smith, Mr Moreno, Mr Roberts, Mr Scicluna and Mr Watson are members. The committee reviews the structure, size and composition of the board; oversees the selection process for prospective directors; makes recommendations to the board on potential appointments and re-appointments of directors at the end of their specified term; considers board succession; reviews the board's governance arrangements to ensure that they are consistent with best corporate governance standards; and oversees the Company's implementation of governance requirements eg under the Walker Review and Combined Code.

The committee is responsible for overseeing the process for appointments of new non-executive directors and making recommendations to the board. In 2010, three new non-executive director appointments were announced. All appointments are subject to a rigorous search and selection process.

In addition, on 3 November 2010, the appointment of António Horta-Osório as Group Chief Executive of Lloyds Banking Group was recommended to, and approved by, the board, following the process set out below.

The committee's terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

### GROUP CHIEF EXECUTIVE'S SUCCESSION

In September 2010, immediately following the announcement of Mr Daniels' retirement, a sub-committee of the board (the Succession Committee) was established under the Chairmanship of Sir Winfried Bischoff to lead the search for a suitable successor. Other members of the Succession Committee were Lord Leitch (Deputy Chairman), Mr Moreno (Senior Independent Director) and Mr Watson (Chairman of the remuneration committee), all independent non-executive directors. The Succession Committee met at least once a week between September and November 2010 and was supported by the Group HR Director and the Head of Secretariat.

The Succession Committee's remit was to appoint a successor who would be capable of leading the Group to the next stage of its development. It was agreed that an extensive search should be conducted encompassing internal, external and international candidates. Given the profile, breadth and challenges of the role, together with the need to be able successfully to lead the Group in the next phase of its development, it was clear that an exceptional candidate was required.

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The starting point for identification of suitable candidates was our Chief Executive Succession plan which included Mr Horta-Osório. Other candidates, including one internal candidate, were also considered.

Mr Horta-Osório stood out in an excellent short list. His skills closely match the role specification agreed by the Succession Committee including:

strong retail and commercial banking experience gained in the UK and internationally, including experience at chief executive officer level, of running large scale, multi-product, multi-brand businesses;

a proven track record of successful integration of retail banks in the UK and in Europe as part of a multi-jurisdictional, multi-brand organisation;

strong understanding of the operational and regulatory environment in which banks operate both in the UK and globally, including a deep understanding of capital and liquidity management and the potential impacts of global regulatory change initiatives;

the ability to foster a culture of fairness for customers, shareholders and colleagues; and

the ability to provide leadership and strategic direction, to deliver growth in tough market conditions.

Following an intensive interview process and extensive due diligence, Mr Horta-Osório was named as the Company's new Group Chief Executive in November 2010.

### **REMUNERATION COMMITTEE**

Information about the remuneration committee's membership and work is given on page 119. Its terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

### **RISK COMMITTEE**

The risk committee comprises Mr Roberts (chairman), Sir Winfried Bischoff, Ms Frew, Sir Julian Horn-Smith, Mr Ryan and Mr Scicluna. The risk committee's duties include overseeing the development, implementation and maintenance of the Group's overall risk management framework,



## CORPORATE GOVERNANCE

and its risk appetite, strategy, principles and policies, to ensure they are in line with emerging regulatory, corporate governance and industry best practice. The committee also oversees the Group's risk exposures; facilitates the involvement of non-executive directors in risk issues and aids their understanding of these issues; oversees adherence to Group risk policies and standards and considers any material amendments to them; and reviews the work of the group risk function.

## GROUP EXECUTIVE COMMITTEE

The group executive committee, comprising the group chief executive, all the group executive directors (as shown on pages 117 to 118), together with the chief risk officer, the group human resources director and the director of group operations, meets to assist the group chief executive in performing his duties. Specifically, the committee considers the development and implementation of strategy, operational plans, policies and budgets; the monitoring of operating and financial performance; the assessment and control of risk; the prioritisation and allocation of resources; and the monitoring of competitive forces in each area of operation. The committee, assisted by its sub-committees, the group business risk and group asset and liability committees, also supports the group chief executive in endeavouring to ensure the development, implementation and effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, and in reviewing the Group's aggregate risk exposures and concentrations of risk.

## ATTENDANCE AT MEETINGS

The attendance of directors at board meetings and at meetings of the audit, nomination & governance, remuneration and risk committees during 2010 are shown in the table. Some directors attended relevant committee meetings as attendees periodically throughout the year, which are not shown below. In addition, the audit committee arranged six half-day 'deep dive' meetings during 2010 which were open to and attended by other members of the board.

	Board meetings			Audit committee		Nomination & governance committee		Remuneration committee		Risk committee	
	Regular	Ad hoc	Total	Regular	Ad hoc	Regular	Ad hoc	Regular	Ad hoc	Regular	Ad hoc
Number of meetings during the year	9	8	17	7	1	3	2	4	11	4	
<b>Current directors who served during 2010</b>											
Sir Winfried Bischoff	9	7	16			3	2	4	11	4	
A M Frew <sup>1</sup>	1(1)		1	1(1)							
Sir Julian Horn-Smith	9	4	13			1	2	3	6	4	
A G Kane	9	7	16								
Lord Leitch <sup>2</sup>	8	8	16	7	1	3	1	4	11	2(2)	
G Moreno <sup>3</sup>	7	6(7)	13			2(2)	1(1)		4(5)	2(2)	
D Roberts <sup>4</sup>	7	6(7)	13	5(5)	1	1(2)	(1)	3(3)	7(8)	3(3)	
T T Ryan <sup>5</sup>	9	6	15	7				3(3)	6(8)	4	
M A Scicluna <sup>6</sup>	9	7	16	7	1	2(2)				4	
G T Tate	9	8	17								
T J W Tookey	9	8	17								
A Watson <sup>7</sup>	9	6	15	7	1	2(2)		3(3)	7(8)	2(2)	
H A Weir	9	8	17								
<b>Former directors who served during 2010</b>											
J E Daniels <sup>8</sup>	9	7	16								
	4	2(3)	6			1(1)	2(2)	2(2)	6(6)		

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Dr W C G  
Berndt<sup>9</sup>

- 1 Appointed to the board, audit and risk committees on 1 December 2010.
- 2 Stood down from the risk committee on 14 April 2010.
- 3 Appointed to the board, nomination & governance, remuneration and risk committees on 1 March 2010. Stood down from the remuneration committee on 17 June 2010 and the risk committee on 1 September 2010.
- 4 Appointed to the board, audit, remuneration and risk committees on 1 March 2010. Appointed as chairman of the risk committee and to the nomination & governance Committee with effect from 1 September 2010.
- 5 Appointed to the remuneration committee on 1 March 2010.
- 6 Appointed to the nomination & governance committee on 6 May 2010.
- 7 Appointed as chairman of the remuneration committee and to the nomination & governance committee, and stood down from the risk committee, on 6 May 2010.
- 8 Left the board on 28 February 2011.
- 9 Left the board, nomination & governance and remuneration committees on 6 May 2010.

Where a director served for only part of the year, the maximum possible number of meetings that the director could have attended is shown in brackets.

## CORPORATE GOVERNANCE

### **COMPLIANCE WITH THE BRITISH BANKERS ASSOCIATION DRAFT CODE FOR FINANCIAL REPORTING DISCLOSURE**

In September 2010, the British Bankers Association published a Code for Financial Reporting Disclosure (the Disclosure Code). The Disclosure Code sets out five disclosure principles together with supporting guidance. The principles are that UK banks: commit to providing high quality, meaningful and decision-useful disclosures; commit to ongoing review of, and enhancement to, their financial instrument disclosures for key areas of interest; will assess the applicability and relevance of good practice recommendations to their disclosures acknowledging the importance of such guidance; will seek to enhance the comparability of financial statement disclosures across the UK banking sector; and will clearly differentiate in their annual reports between information that is audited and information that is unaudited.

The Group and other major UK banks have voluntarily adopted the Disclosure Code in their 2010 financial statements. The Group's 2010 financial statements have therefore been prepared in compliance with the Disclosure Code's principles.

### **INTERNAL CONTROL**

The board of directors is responsible for the establishment and review of Lloyds Banking Group's system of internal control, which is designed to ensure effective and efficient operations, quality of internal and external reporting, internal control, and compliance with laws and regulations. It should be noted, however, that such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives. In establishing and reviewing the system of internal control, the directors have regard to the nature and extent of relevant risks, the likelihood of a loss being incurred and the costs of control. It follows, therefore, that the system of internal control can only provide reasonable but not absolute assurance against the risk of material loss.

The directors and senior management are committed to maintaining a control-conscious culture across all areas of operation. This is communicated to all employees by way of published policies and procedures and regular management briefings. A requirement to comply with internal control risk policies is a key component of individual staff objectives expressed in the balanced scorecard. Key business risks are identified, and these are controlled by means of procedures such as physical controls, credit, trading and other authorisation limits and segregation of duties. In addition, there is an annual control self assessment exercise whereby the key businesses and head office functions review specific controls and attest to the accuracy of their assessments. The assessment covers all enterprise-wide risk management categories and is in accordance with the principles of the Combined Code. As in previous years, this exercise was completed for the year ended 31 December 2010. All returns have been satisfactorily completed and appropriately certified.

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

### **DISCLOSURE CONTROLS AND PROCEDURES**

As of 31 December 2010, Lloyds Banking Group, under the supervision and with the participation of the Group's management, including the Group Chief Executive and the Group Finance Director, performed an evaluation of the effectiveness of the Group's disclosure controls and procedures. Based on this evaluation, the Group Chief Executive and Group Finance Director concluded that the Company's disclosure controls and procedures, as at 31 December 2010, were effective for gathering, analysing and disclosing with reasonable assurance the information that Lloyds Banking Group is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms. The Lloyds Banking Group's management necessarily applied its judgement in assessing the costs and benefits of such controls and procedures, which by their nature can provide only reasonable assurance regarding management's control objectives.

### **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There have been no changes in the Lloyds Banking Group's internal control over financial reporting during the year ended 31 December 2010 that have materially affected, or are reasonably likely to materially affect, the Lloyds Banking Group's internal control over financial reporting.

## MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Lloyds Banking Group plc is responsible for establishing and maintaining adequate internal control over financial reporting. Lloyds Banking Group plc's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with IFRS and that receipts and expenditures are being made only in accordance with authorisations of management and directors of Lloyds Banking Group plc; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Internal control systems, no matter how well designed, have inherent limitations and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

The management of Lloyds Banking Group plc assessed the effectiveness of the Company's internal control over financial reporting as at 31 December 2010 based on the criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in its report *Internal Control - Integrated Framework*. Based on this assessment, management concluded that, as at 31 December 2010, the Company's internal control over financial reporting was effective.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has issued an audit report on the Company's internal control over financial reporting as of 31 December 2010. This report appears on page F-2.

## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### MAJOR SHAREHOLDERS

At 6 May 2011, notification had been received that The Solicitor for the Affairs of Her Majesty's Treasury had a direct interest of 40.6 per cent (27,608,563,642 ordinary shares) in the Company's issued share capital with rights to vote in all circumstances at general meetings. No other notification has been received that anyone has an interest of 3 per cent or more in the Company's issued ordinary share capital. Further information on The Solicitor for the Affairs of Her Majesty's Treasury's shareholding in the Company is provided in *Information about the Lloyds Banking Group's relationship with the UK Government and Business History and development of Lloyds Banking Group*.

All shareholders within a class of the Company's shares have the same voting rights.

### RELATED PARTY TRANSACTIONS

The Group, as at 31 December 2010, had related party transactions with 15 key management personnel and certain of its pension funds, OEICs and joint ventures and associates. See note 53 to the consolidated financial statements. In addition, material contracts with HM Treasury are described in the *Information about the Lloyds Banking Group's relationship with the UK Government* section below.

Except as described in *Business - Material contracts* and below under *Information about the Lloyds Banking Group's relationship with the UK Government*, there are no transactions to which the Group is a party involving the UK Government or any body controlled by the UK Government which are material to the Group or, to the Group's knowledge, to the UK Government or any UK Government controlled body, that were not made in the ordinary course of business, or that are unusual in their nature or conditions. However, considering the nature and scope of the bodies controlled by the UK Government, it may be difficult for the Group to know whether a transaction is material for such a body.

To the best of the Group's knowledge, any outstanding loans made by the Group to or for the benefit of the UK Government, any body controlled by the UK Government or other related parties, were made (1) in the ordinary course of business, (2) on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with other persons, (3) did not involve more than the normal risk of collectability or present other unfavourable features, and (4) were made on arm's length basis.

The Group also engages in numerous transactions on arm's length commercial terms in the ordinary course of its business with the Government and its various departments and agencies, as well as with other companies in which the Government has invested. This includes financings, lending, banking, asset management and other transactions with UK financial institutions in which the Government has invested. During 2009 and 2010 the Group made use of these measures in order to maintain and improve a stable funding position.

### INFORMATION ABOUT THE LLOYDS BANKING GROUP'S RELATIONSHIP WITH THE UK GOVERNMENT

#### HM TREASURY SHAREHOLDING

As at 6 May 2011, the Solicitor for the Affairs of Her Majesty's Treasury (as nominee for HM Treasury) notified the Company that it has a direct interest of 40.6 per cent. in the Company's issued share capital with rights to vote in all circumstances at general meetings.

HM Treasury's shareholding in the Company is currently managed by UKFI on behalf of HM Treasury. This relationship falls within the scope of the revised framework document between HM Treasury and UKFI published on 1 October 2010 for more information see *Risk Factors - Government Related Risks - The Commissioners of Her Majesty's Treasury (HM Treasury) is the largest shareholder of the Company. Through its shareholding in, and other relationships with, the Company, HM Treasury is in a position to exert significant influence over the Group and its business.*

The goals of the framework document are consistent with the stated public policy aims of HM Treasury, as articulated in a variety of public announcements (as at 6 May 2011). In the publication *An Introduction: Who We Are, What We Do and the Framework Document Which Governs the Relationship Between UKFI and HM Treasury*, it is stated that UKFI is to *develop and execute an investment strategy for disposing of the investments in the banks in an orderly and active way through sale, redemption, buy-back*

*or other means within the context of an overarching objective of protecting and creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition* . UKFI has also stated that it intends to *engage robustly with banks boards and management, holding both strategy and financial performance to account, and taking a strong interest in getting the incentives structures right on the board and beyond accounting properly for risk and avoiding inefficient rewards for failure* .

HM Treasury's shareholding in the Company is a consequence of its subscription for equity securities of the Company and of HBOS (prior to the acquisition of HBOS by the Company) in the 2008 placing and open offer and preference share subscription, the concomitant placing and open offer by HBOS, the 2009 Placing and Open Offer and the Company's 2009 Rights Issue, each of which is briefly described below.

#### **THE 2008 PLACING AND OPEN OFFER**

In September 2008, with the support of the UK Government, the boards of the Company and HBOS announced their agreement on the terms of a recommended acquisition by the Company of HBOS. In October 2008, in the context of further turbulence in global financial markets and as part of a co-ordinated package of capital and funding measures for the UK banking sector implemented by HM Treasury, the boards of both the Company and HBOS announced that they intended to participate in the proposed UK Government funding package and that they had agreed to proceed with the acquisition on revised terms. In this context, a combined total of £17,000 million of new capital was raised, consisting of £4,500 million in ordinary shares and £1,000 million in preference shares (before costs and expenses) by the Company and £8,500 million in ordinary shares and £3,000 million in preference shares (before costs and expenses) by HBOS.

In the 2008 placing and open offer, the Company in October 2008 invited qualifying shareholders to acquire open offer shares at an issue price of 173.3 pence per ordinary share. HM Treasury agreed that to the extent not placed by the joint sponsors and joint bookrunners or taken up in the open offer, HM Treasury would acquire the open offer shares at the issue price. The 2008 placing and open offer was completed with the placement of 2,596,653,203 shares at the issue price. The Company gave certain customary representations and warranties and indemnities to each of HM Treasury, the joint sponsors and joint bookrunners under the 2008 placing and open offer agreement that are unlimited as to time and amount. The Company and HM Treasury also entered into a preference share subscription agreement in October 2008 whereby HM Treasury acquired 1,000,000 new preference shares of the Company for a total consideration of £1,000 million (before costs and expenses).

HBOS also entered into a placing and open offer agreement in October 2008 with HM Treasury and the HBOS joint sponsors and joint bookrunners on similar terms and for similar purposes as the Company. A total of 7,482,394,366 HBOS open offer shares were offered at the issue price of 113.6 pence per share. HBOS also entered into a preference share subscription agreement with HM Treasury pursuant to which HM Treasury acquired new HBOS preference shares for a total consideration of £3,000 million (before costs and expenses).

## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

Pursuant to these placings and open offers by the Company and HBOS and the acquisition of HBOS by the Company, HM Treasury acquired in January 2009 43.4 per cent. of the Company's issued ordinary share capital. In addition, £3,000 million non-cumulative 12 per cent fixed to floating rate preference shares were issued by the Company to HM Treasury on 16 January 2009 in exchange for the £3,000 million preference shares which had been issued by HBOS to HM Treasury on 15 January 2009 (as referred to above).

The Company and HM Treasury in January 2009 entered into a registration rights agreement with HM Treasury granting customary demand and piggyback registration rights in the United States under the United States Securities Act of 1933, as amended to HM Treasury with respect to any ordinary shares of the Group held by HM Treasury. HM Treasury may transfer its registration rights to any third party to whom it transfers not less than U.S.\$500 million in registrable securities. The customary piggyback registration rights provide that holders of registrable securities may participate in an offering of ordinary shares by the Group registered under the Securities Act to the extent that such participation would not prevent successful completion of the offering. All holders of registrable securities have piggyback registration rights, on a pro rata basis, in any demand registration made by another holder pursuant to the registration rights agreement. The registration rights agreement was amended in June 2009 to include as registrable securities the new shares subscribed for by HM Treasury in the 2009 placing and compensatory open offer described below, any other securities in the Company called by HM Treasury to be issued by any person and any securities issued by HM Treasury which are exchangeable for, convertible into, give rights over or are referable to any such securities.

### THE 2009 COMPENSATORY PLACING AND OPEN OFFER

Pursuant to a placing and open offer agreement among the Company, HM Treasury and the joint sponsors and joint bookrunners dated March 2009, the Company in June 2009 issued approximately 10,408 million new ordinary shares as part of a placing and compensatory open offer. HM Treasury subscribed for its pro rata share, being approximately 4,521 million new ordinary shares at a price of 38.43 pence per share. As placees were procured for all the new ordinary shares for which valid acceptances were not received under the placing and compensatory open offer, HM Treasury's shareholding remained at 43.4 per cent. The Company used the proceeds from this placing and compensatory open offer to redeem the £4,000 million preference shares issued by the Company to HM Treasury, described above, at 101 per cent. of their issue price together with accrued dividends thereon.

In consideration for the provision of its services under the 2009 placing and open offer agreement, the Company paid to HM Treasury (i) a commission of 0.5 per cent. of the aggregate value of the open offer shares at the issue and (ii) a further commission of 1 per cent. of the aggregate value of the open offer shares subscribed for by HM Treasury (or its nominee) or by placees (including, for the avoidance of doubt, HM Treasury) at the issue price per open offer share. The Company also bore all costs and expenses relating to the placing and compensatory open offer, including those of HM Treasury, the joint sponsors and joint bookrunners and those of HM Treasury's financial advisers. The Company gave certain customary representations and warranties and indemnities to each of HM Treasury and the joint sponsors and joint bookrunners. The Company's liabilities thereunder are unlimited as to time and amount.

The Company also in June 2009 entered into a resale rights agreement with HM Treasury in which it agreed to provide its assistance to HM Treasury in connection with any proposed sale by HM Treasury of ordinary shares, other securities held by HM Treasury in the Company or any securities of any description caused by HM Treasury to be issued by any person which are exchangeable for, convertible into, give rights over or are referable to such ordinary shares or other securities issued by the Group, to be sold in such jurisdictions (other than the United States) and in such manner as HM Treasury may determine. Such assistance may include, the provision by the Company of assistance with due diligence and the preparation of marketing and such other documentation (including any offering memorandum, whether or not a prospectus) as HM Treasury may reasonably request.

### 2009 RIGHTS ISSUE

In December 2009 the Company also issued approximately 36,505 million new ordinary shares in a Rights Issue (together with a liability management exercise) as part of an alternative to the Group's proposed participation in GAPS. The Company entered into an Undertaking to Subscribe agreement with HM Treasury whereby HM Treasury took up its rights to subscribe for all of the new shares to which it was entitled under the Rights Issue. HM Treasury subscribed for its pro rata share, being approximately 15,854 million new shares at a price of 37 pence per share. As subscribers were procured for all the new ordinary shares for which valid acceptances were not received under the Rights Issue, HM Treasury's shareholding again remained at 43.4 per cent. Its current, lower shareholding results from further share issuance in the context of previously announced liability management exercises and employee remuneration during the course of 2010 and 2011.

The Company also agreed to pay to HM Treasury the HMT commitment commission, being a commission of up to £143.7 million, in consideration, amongst other things, for the undertakings given by HM Treasury in the HMT undertaking to subscribe.

**OTHER RELATED PARTY TRANSACTIONS WITH THE UK GOVERNMENT**

**CREDIT GUARANTEE SCHEME**

HM Treasury launched the Credit Guarantee Scheme in October 2008 as part of a range of measures announced by the UK Government intended to ease the turbulence in the UK banking system. It charged a commercial fee for the guarantee of new short and medium term debt issuance. The fee payable to HM Treasury on guaranteed issues was based on a per annum rate of 50 basis points plus the median five-year credit default swap spread. The drawdown window for the Credit Guarantee Scheme closed for new issuance at the end of February 2010. At 31 December 2010, the Group had £45,308 million of debt in issue under the Credit Guarantee Scheme. During the year, fees of £454 million paid to HM Treasury in respect of guaranteed funding were included in the Group's income statement.

As at 31 December 2010, the Group's overall liquidity support from public and central bank sources had reduced to £96.6 billion, compared to £157 billion at 31 December 2009. All of the remaining balance, including all the Special Liquidity Scheme and Credit Guarantee Scheme facilities, matures over the course of the next two years although the Directors believe that the Group's balance sheet reduction plans and deposit strategy will avoid the necessity to refinance much of this.

**LENDING COMMITMENTS**

The formal lending commitments entered into in connection with the Group's proposed participation on GAPS have now expired and in February 2011, the Company (together with Barclays, RBS, HSBC and Santander) announced, as a part of the Project Merlin agreement with HM Treasury, its capacity and willingness to increase gross business lending (including to small and medium-sized enterprises) during 2011. For more information on Project Merlin see *Risk Factors - Government related risks*.



## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### GAPS WITHDRAWAL DEED

Pursuant to the successful Rights Issue, the Company withdrew from its proposed participation in GAPS. In November 2009, the Company entered into the GAPS withdrawal deed with HM Treasury pursuant to which, among other matters, the Company paid HM Treasury £2,500 million in recognition of the benefits to the Group's trading operations arising as a result of HM Treasury proposing to make GAPS available to the Group. Under a cost reimbursement deed, the Group agreed in November 2009 to pay for the UK Government's set-up costs relating to the proposed participation of the Group in GAPS (including all costs of the UK Government relating to the proposed participation of the Group in, and its withdrawal from its proposed participation in GAPS) and the UK Government's costs associated with the European Commission's approval of state aid to the Group.

The GAPS withdrawal deed contained certain undertakings given by the Group to HM Treasury in connection with the state aid approval obtained from the European Commission (on which see the sub-section entitled "State Aid" below) and its withdrawal from its proposed participation in GAPS. In particular, the Group is required to do all acts and things necessary to ensure the UK Government's compliance with its obligations under the European Commission decision approving state aid to the Group. This undertaking includes an obligation to: (i) comply with the restructuring measures that the Group agreed to undertake; (ii) comply with the terms of the Restructuring Plan; and (iii) provide certain information to HM Treasury and do such acts as are necessary to enable compliance with the state aid approval to be monitored. The GAPS withdrawal deed also provides for the Group's restructuring obligations to be modified in certain limited circumstances (without prejudice to any challenge to such state modifications). However, HM Treasury has undertaken that it will not, without the consent of the Company, agree modifications to the Group's undertakings with respect to state aid which are significantly more onerous to the Company than those granted in order to obtain the state aid approval.

It was also agreed that if the European Commission adopted a decision that the United Kingdom must recover any state aid, the Group would repay all such state aid (subject to the Group's right to challenge any such decision in the European courts).

The GAPS withdrawal deed included a number of other commitments given by the Company to HM Treasury. The Company, among other things:

- (i) acknowledged its commitment to the principle that it should be at the leading edge of implementing the G20 principles, the FSA Code on remuneration and any remuneration provisions accepted by the Government from the Walker Review, provided that this principle shall always be applied in such a way as to allow the Company to operate on a level playing field with its competitors. In addition, the Group agreed with HM Treasury the specific deferral and clawback terms which applied to bonuses in respect of the 2009 performance year;
- (ii) reaffirmed its lending commitments;
- (iii) agreed to implement a (now published) customer charter for lending to businesses;
- (iv) committed:
  - a. to ensure that its public financial statements comply with best industry practice; and
  - b. to enter into discussions with HM Treasury with a view to ensuring that such public financial statements: (A) enable investors to assess the quality of the assets and liabilities of banking institutions, the financial position and performance of banking institutions and the nature and extent of risks arising from financial instruments to which banking institutions are exposed; and (B) are comparable as between similar banking institutions;
- (v) agreed to develop with the FSA, and implement, a medium term funding plan aimed at reducing dependence on short term funding to be regularly reviewed by the FSA and other members of the Tripartite Authorities; and
- (vi) agreed to implement any measures relating to personal current accounts agreed between the OFT and the UK banking industry: (i) as detailed in the OFT's report "Personal current accounts in the UK: a follow up report, October 2009" and (ii) relating to fees and charges, and the terms and conditions of personal current accounts where any such measures are within the scope of current negotiations with respect thereto.

### STATE AID

As part of the European Commission's decision approving state aid to the Group, the Group was required to submit the Restructuring Plan to the European Commission in the context of a state aid review. The plan was required to contain measures to

limit any competition distortions resulting from the state aid received by the Group and to restore the Group's viability. The College of Commissioners announced its formal approval of the state aid on 18 November 2009 and concluded that the Restructuring Plan was appropriate to restore the Group's viability, to achieve sufficient burden sharing and to off-set the distortions of competition created by the state aid.

The Restructuring Plan consists of the following principal elements: (i) the disposal of a retail banking business with at least 600 branches, a 4.6 per cent. share of the personal current accounts market in the UK and up to 19.2 per cent. of Lloyds Banking Group's mortgage assets; (ii) an asset reduction programme to achieve £181 billion reduction in a specified pool of assets by 31 December 2014; and (iii) behavioural commitments, including commitments which restrict the Group's ability to make certain acquisitions for approximately three to four years and not to make discretionary payments of coupons or to exercise voluntary call options on hybrid securities from 31 January 2010 until 31 January 2012, which prevents Lloyds Banking Group from paying dividends on its ordinary shares for the same duration.

The retail banking business referred to in (i) above is to be disposed of before the end of November 2013 and consists of the TSB brand, the branches, savings accounts and branch-based mortgages of Cheltenham & Gloucester, the branches and branch-based customers of Lloyds TSB Scotland and a related banking licence, additional Lloyds TSB branches in England and Wales, with branch-based customers and Intelligent Finance.

The Group is working closely with the European Commission, HM Treasury and the Monitoring Trustee appointed by the European Commission to ensure the implementation of the Restructuring Plan. On 1 March 2011, the Group announced that in order to meet its obligations under the State Aid Commitments and to ensure that the Group maintains the maximum flexibility in its options, the Group is accelerating the start of the disposal of the retail banking business referred to in (i) above.

#### OTHER RELATIONSHIPS WITH THE UK GOVERNMENT

The Group, in common with other financial institutions, is also working closely with a number of Government departments and agencies on various industry-wide initiatives that are intended to support the Government's objective of greater stability in the wider financial system. These initiatives currently include the potential extension of the Bank of England's discount window facility whereby banks and building societies can exchange eligible securities and, potentially, other asset classes for HM Treasury gilts.

## REGULATION

### OVERVIEW OF UK REGULATION

The FSA has responsibility under the Financial Services and Markets Act (2000) (FSMA) for the regulation and oversight of a wide range of financial services activities in the UK and is responsible for the authorisation and supervision of institutions that perform regulated activities as defined in the FSMA. As at 31 December 2010, there were 40 UK authorised institutions across the Group which are regulated by the FSA on both an individual and a consolidated basis.

### REGULATORY APPROACH OF THE FSA

The FSA's regulatory approach requires senior management of a financial institution to ensure that it takes reasonable care to organise and control its affairs responsibly and effectively and that it develops and maintains adequate risk management systems.

The FSA Handbook sets out rules and guidance across a range of issues with which financial institutions are required to comply including prudential rules relating to capital adequacy and liquidity, high level principles of business and detail conduct of business standards and reporting standards.

The UK Government has announced plans to give the Bank of England macro- and micro-prudential supervisory powers over UK regulated banks and to create a new Customer Protection and Markets Authority (to be renamed the Financial Conduct Authority) to take over the FSA's conduct of business supervisory role, together with certain other duties from the FSA and other bodies.

### OTHER BODIES IMPACTING THE REGULATORY REGIME

#### THE BANK OF ENGLAND AND HM TREASURY

The agreed framework for co-operation in the field of financial stability in the financial markets is detailed in the Memorandum of Understanding published jointly by the Tripartite Authorities. The Bank of England has specific responsibilities in relation to financial stability, including: (i) ensuring the stability of the monetary system; (ii) oversight of the financial system infrastructure, in particular payments systems in the UK and abroad; and (iii) maintaining a broad overview of the financial system through its monetary stability role and the deputy governor's membership of the FSA's Board. The Tripartite Authorities work together to achieve stability in the financial markets.

The Banking Act provides the Tripartite Authorities with the tools for dealing with failing institutions as part of the Special Resolution Regime (the SRR). These powers are designed to enable the Tripartite Authorities to deal with and stabilise UK-incorporated institutions with permission to accept deposits pursuant to Part IV of the FSMA (each, a relevant entity) that are failing or are likely to fail to satisfy certain threshold conditions (within the meaning of section 41 of the FSMA, being the conditions that a relevant entity must satisfy in order to retain its authorisation to perform regulated activities).

The SRR consists of three stabilisation options: (i) transfer of all or part of the business of the relevant entity or the shares of the relevant entity to a private sector purchaser; (ii) transfer of all or part of the business of the relevant entity to a bridge bank wholly-owned by the Bank of England; and (iii) temporary public ownership of the relevant entity. HM Treasury may also take a parent company of a relevant entity into temporary public ownership where certain conditions are met.

#### UK FINANCIAL OMBUDSMAN SERVICE (FOS)

The FOS provides customers with a free and independent service designed to resolve disputes where the customer is not satisfied with the response received from the regulated firm. The FOS resolves disputes for eligible persons that cover most financial products and services provided in (or from) the UK. The jurisdiction of the FOS extends to include firms conducting activities under the Consumer Credit Act. Although the FOS takes account of relevant regulation and legislation, its guiding principle is to resolve cases on the basis of what is fair and reasonable; in this regard, the FOS is not bound by law or even its own precedent. The decisions made by the FOS are binding on regulated firms.

#### THE FINANCIAL SERVICES COMPENSATION SCHEME (FSCS)

FSCS was established under the FSMA and is the UK's statutory fund of last resort for customers of authorised financial services firms. Companies within the Group are responsible for contributing to compensation schemes in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers. The FSCS can pay compensation to

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customers if a firm is unable, or likely to be unable, to pay claims against it. The FSCS is funded by levies on firms authorised by the FSA, including companies within the Group.

### LENDING STANDARDS BOARD

The Lending Standards Board (formerly the Banking Code Standards Board) is responsible for monitoring and enforcing compliance with the Lending Code introduced on 1 November 2009, which relates to lending to private customers and small businesses.

### UK OFFICE OF FAIR TRADING (OFT)

The OFT is the UK's consumer and competition authority. Its regulatory and enforcement powers impact the banking sector in a number of ways.

### UK INFORMATION COMMISSIONER'S OFFICE

The UK Information Commissioner's Office is responsible for overseeing implementation of the Data Protection Act 1998. This Act regulates, among other things, the retention and use of data relating to individual customers. The Freedom of Information Act 2000 (the FOIA) sets out a scheme under which any person can obtain information held by, or on behalf of, a public authority without needing to justify the request. A public authority will not be required to disclose information if certain exemptions set out in the FOIA apply.

### INDEPENDENT COMMISSION ON BANKING

The Independent Commission on Banking (ICB) was established by the UK Government in June 2010 to examine the banking sector and to make recommendations on structural and related non-structural measures to promote stability and competition in the banking sector.

The ICB will make recommendations covering both:

Structural measures to reform the banking system and promote stability and competition, including the complex issue of separating retail and investment banking functions; and

Related non-structural measures to promote stability and competition in banking for the benefit of consumers and businesses. In considering these measures the ICB will have regard to the legal and operational requirements of implementing the options under consideration, and the importance of generating practical recommendations. It will also take into account the findings of ongoing EU and international work, and inform the UK Government's approach to international discussions on the financial system.

## REGULATION

The ICB will also have regard to the Government's wider goals of financial stability and creating an efficient, open, robust and diverse banking sector, with specific attention paid to the potential impact of its recommendations on:

Financial stability;

Lending to UK consumers and businesses and the pace of economic recovery;

Consumer choice;

The competitiveness of the UK financial and professional services sectors and the wider UK economy; and

Risks to the fiscal position of the Government.

The ICB published its interim report on 11 April 2011. The Group believes that its through the cycle relationship based strategy is consistent with the aims of the ICB but at this time it is not possible to gauge the final impact of the review on the Group. The Group has cooperated fully with the ICB to date.

The final report for the Cabinet Committee on Banking is expected to be published by the end of September 2011 prior to which there will be a further period of consultation and the Group expects to continue to be at the forefront of the debate with the ICB.

For more information on the ICB and the recommendations in its interim report see *Risk factors – Competition related risks – The Independent Commission on Banking and the UK Treasury Select Committee are reviewing competition in the UK Retail banking industry. The outcomes of these reviews could have a material adverse effect on the interests of the Group.*

## EU REGULATION

The UK has implemented all of the directives introduced under the Financial Services Action Plan. However, these directives are regularly reviewed at EU level and could be subject to change. The Group will continue to monitor the progress of these initiatives, provide specialist input on their drafting and assess the likely impact on its business.

The proposals of the Basel Committee on Banking Supervision, known as Basel III include increased minimum levels of, and quality standards for, capital, increased risk weighting of assets and the introduction of a minimum leverage ratio and additional capital buffers. The final details of these reforms and the impact on the cost of capital are still to be clarified, particularly as the reforms are to be implemented with the European Union and within the UK.

## U.S. OPERATIONS AND REGULATION

In the United States, Lloyds TSB Bank plc maintains a branch in New York and an agency in Miami, licensed by the States of New York and Florida, respectively. Lloyds Banking Group maintains representative offices in several US cities. The existence of branch and agency offices in the US subjects Lloyds Banking Group plc and its subsidiaries doing business or conducting activities in the US to oversight by the Federal Reserve Board and limits the nature of the activities in which Lloyds Banking Group plc and its subsidiaries can engage in the US. Lloyds TSB Bank's branch and agency offices are subject to extensive federal and state supervision and regulation relating to their operations.

The Group's US broker dealer, Lloyds Securities Inc., is subject to regulation and supervision by the US Securities and Exchange Commission (the SEC) and the Financial Industry Regulatory Authority with respect to its securities activities, including sales methods, trade practices, use and safekeeping of customers' funds and securities, capital structure, recordkeeping, the financing of customers' purchases and the conduct of directors, officers and employees.

On 21 July 2010, the United States enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which provides a broad framework for significant regulatory changes that will extend to almost every area of US financial regulation. Many of the provisions of the Dodd-Frank Act and regulations which the Financial Stability Oversight Council or the Consumer Financial Protection Bureau established under the Dodd-Frank Act may adopt will affect the operations of the Group's non-banking subsidiaries in the US, as well as Lloyds TSB Bank plc's US banking operations. The impact of the Dodd-Frank Act and its implementing regulations on the Group's US operations will depend on the final regulations ultimately adopted by various US regulatory authorities in 2011. See also *Risk Factors – Legal and Regulatory Risks – The Group's businesses are subject to substantial regulation, and regulatory and governmental oversight. Adverse regulatory developments or changes in government policy could have a significant material adverse effect on the Group's results of operations, financial condition and prospects for*

further details on the Dodd-Frank Act.

A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with US economic sanctions, with serious legal and reputational consequences for any failures arising in these areas. The Group engages, or has engaged, in a limited amount of business with counterparties in certain countries which the US State Department currently designates as state sponsors of terrorism, including Iran, Syria, Cuba, and Sudan. In January 2008, the Group introduced an enhanced financial sanctions policy which applies to all of the Group's operations and severely restricts activity with certain high risk jurisdictions including the countries designated by the US State Department. From their acquisition in January 2009, HBOS plc and its subsidiaries became subject to the same policy and the Group has undertaken the activities necessary to implement policy requirements across the heritage-HBOS businesses. The Group continues to reduce its outstanding exposures to such states which have arisen through historical business activity. In accordance with this policy, the Group intends to engage only in new business in such jurisdictions in very limited circumstances where the Group is satisfied concerning legal, compliance and reputational issues.

Since its implementation the policy has resulted in a significant reduction in the contacts that the Group had (in terms of value and volume) and the Group expects a further reduction in its contacts in the coming years. The Group does not have, and does not anticipate having, a physical presence in any of the countries designated as state sponsors of terrorism.

At 31 December 2010, the Group does not believe the Group's business activities relating to countries designated as state sponsors of terrorism were material to its overall business.

The Group estimates that the value of the Group's business in respect of such states represented less than 0.015 per cent of the Group's total assets and, for the year ended 31 December 2010, the Group believes that the Group's revenues from all activities relating to such states were less than 0.005 per cent of its total income net of insurance claims. This information has been compiled from various sources within the Group, including information manually collected from relevant business units, and this has necessarily involved some degree of estimate and judgement.

## **REGULATORY ACTIONS**

### **FSA SUPERVISORY REVIEW INTO HISTORICAL HBOS DISCLOSURES**

The FSA is conducting a supervisory review into the accuracy and completeness of financial disclosures, made by HBOS in connection with its capital raisings in 2008, including information as to corporate impairments disclosed in the circulars and/or prospectuses issued by HBOS in connection with such capital raisings. The Group is cooperating fully with this review.

Other legal and regulatory matters in which the Group is currently involved are discussed on page 7 under *Legal Actions*.

## LISTING INFORMATION

The information in this section has been extracted from publicly available documents from various sources, including officially prepared materials from the London Stock Exchange, and has not been prepared or independently verified by the Lloyds Banking Group.

The ordinary shares of Lloyds Banking Group plc are listed and traded on the London Stock Exchange under the symbol LLOY.L. The prices for shares as quoted in the official list of the London Stock Exchange are in pounds sterling. The following table shows the reported high and low closing prices for the ordinary shares on the London Stock Exchange. This information has been extracted from publicly available documents from various sources, including officially prepared materials from the London Stock Exchange, and has not been prepared or independently verified by the Lloyds Banking Group.

	Price per share (in pence) High	Price per share (in pence) Low
Annual prices:		
2010	77.61	46.59
2009	140.70	40.30
2008	483.25	118.50
2007	614.00	451.25
2006	581.00	489.75
2005	509.00	439.50
2004	476.25	391.75
2003	483.00	295.75
2002	817.00	427.50
2001	772.00	590.00
2000	774.50	517.00
Quarterly prices:		
2011		
First quarter	69.61	58.09
2010		
Fourth quarter	76.39	60.41
Third quarter	77.61	52.21
Second quarter	70.24	50.52
First quarter	64.91	46.59
2009		
Fourth quarter	99.23	48.70
Third quarter	111.34	63.30
Second quarter	121.10	61.10
First quarter	140.70	40.30
Monthly prices:		
April 2011	62.36	58.38
March 2011	62.88	58.09
February 2011	69.30	61.96
January 2011	69.61	61.90
December 2010	69.34	64.05
November 2010	70.25	60.41

On 6 May 2011, the closing price of shares on the London Stock Exchange was 54.00 pence, equivalent to \$0.8865 per share translated at the Noon Buying Rate of \$1.6417 per £1.00 on 6 May 2011.

Lloyds Banking Group plc's American Depositary Receipts (ADRs) have been traded on the over-the-counter market in the US under the symbol LLDTY since March 2000. Since 27 November 2001 Lloyds Banking Group plc American Depositary Shares (ADSs) have been listed on The New York Stock Exchange under the symbol LYG. The prices for Lloyds Banking Group plc's ADRs and ADSs, as quoted below, are in US dollars. Each ADS represents four ordinary shares.

## LISTING INFORMATION

The following table shows the reported high and low closing prices for the ADRs in the over-the-counter market in the US.

	Price per ADR (in US dollars) High	Price per ADR (in US dollars) Low
Annual prices:		
2001 (to 26 November 2001)	46.00	34.75
2000	45.27	33.50
Quarterly prices:		
2001		
Fourth quarter (to 26 November 2001)	43.88	38.25
Third quarter	44.00	35.50
Second quarter	43.94	38.94
First quarter	46.00	34.75

The following table shows the reported high and low closing prices for ADSs on the New York Stock Exchange.

	Price per ADS (in US dollars) High	Price per ADS (in US dollars) Low
Annual prices:		
2010	4.85	2.92
2009	8.40	2.22
2008	38.56	7.15
2007	48.44	36.70
2006	45.41	34.72
2005	39.06	31.12
2004	36.88	29.47
2003	32.55	19.65
2002	48.55	27.85
Quarterly prices:		
2011		
First quarter	4.44	3.70
2010		
Fourth quarter	4.83	3.78
Third quarter	4.85	3.23
Second quarter	4.37	3.05
First quarter	3.88	2.92
2009		
Fourth quarter	6.44	3.21
Third quarter	7.37	4.17
Second quarter	7.36	4.10
First quarter	8.40	2.22
2008		
Fourth quarter	18.80	7.15
Third quarter	27.92	15.75
Second quarter	38.56	24.46
First quarter	38.52	31.12
2007		
Fourth quarter	46.95	36.70
Third quarter	47.22	41.25
Second quarter	47.20	44.72
First quarter	48.44	41.64
Monthly prices:		
April 2011	4.03	3.80



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March 2011	4.09	3.70
February 2011	4.44	4.04
January 2011	4.43	3.87
December 2010	4.35	4.00
November 2010	4.57	3.78

On 6 May 2011, the closing price of ADSs on the New York Stock Exchange was \$3.45.

LISTING INFORMATION

**ADR FEES**

The Group's depositary, Bank of New York Mellon, collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depositary collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deductions from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

Persons depositing or withdrawing shares must pay:	For:
\$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)	Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property
	Cancellation of ADSs for the purpose of withdrawal, including if the deposit agreement terminates
\$.02 (or less) per ADS	Any cash distribution to ADS registered holders
A fee equivalent to the fee that would be payable if securities distributed to you had been shares and the shares had been deposited for issuance of ADSs	Distribution of securities distributed to holders of deposited securities which are distributed by the depositary to ADS registered holders
\$.02 (or less) per ADSs per calendar year	Depositary services
Registration or transfer fees	Transfer and registration of shares on our share register to or from the name of the depositary or its agent when you deposit or withdraw shares
Expenses of the depositary	Cable, telex and facsimile transmissions (when expressly provided in the deposit agreement)
	Converting foreign currency to US dollars
Taxes and other governmental charges the depositary or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes	As necessary
Any charges incurred by the depositary or its agents for servicing the deposited securities	As necessary

*FEES RECEIVED TO DATE*

In 2010, the Company received from the depositary \$1,572,758 for continuing annual stock exchange listing fees, standard out-of-pocket maintenance costs for the ADRs (consisting of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of US Federal tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls), any applicable performance indicators relating to the ADR facility, underwriting fees and legal fees.

*FEES TO BE PAID IN THE FUTURE*

The Bank of New York Mellon, as depositary, has agreed to reimburse the Company for expenses they incur that are related to establishment and maintenance expenses of the ADS program. The depositary has agreed to reimburse the Company for its

continuing annual stock exchange listing fees. The depositary has also agreed to pay the standard out-of-pocket maintenance costs for the ADRs, which consist of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of US Federal tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls. It has also agreed to reimburse the Company annually for certain investor relationship programs or special investor relations promotional activities. In certain instances, the depositary has agreed to provide additional payments to the Company based on any applicable performance indicators relating to the ADR facility. There are limits on the amount of expenses for which the depositary will reimburse the Company, but the amount of reimbursement available to the Company is not necessarily tied to the amount of fees the depositary collects from investors.

The depositary collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depositary collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deduction from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

## DIVIDENDS

As a result of the UK Government's investment in the Group as part of the initial recapitalisation by the Company in November 2008, the rights issue announced in November 2009 and our participation in the Credit Guarantee Scheme, the Group has been deemed to have accepted state aid and subsequently the European Commission required the Group to undertake a restructuring plan. This, amongst other things, includes a behavioural commitment not to make discretionary payments of coupons or to exercise voluntary call options on hybrid securities from 31 January 2010 until 31 January 2012. This also prevents the Group from paying dividends on its ordinary shares for the same duration.

Lloyds Banking Group plc's ability to pay dividends is restricted under UK company law. Dividends may only be paid if distributable profits are available for that purpose. In the case of a public limited company, a dividend may only be paid if the amount of net assets is not less than the aggregate of the called-up share capital and undistributable reserves and if the payment of the dividend will not reduce the amount of the net assets to less than that aggregate. In addition, a company cannot pay a dividend if any of its UK insurance subsidiaries is insolvent on a regulatory valuation basis or, in the case of regulated entities, if the payment of a dividend results in regulatory capital requirements not being met. Similar restrictions exist over the ability of Lloyds Banking Group plc's subsidiary companies to pay dividends to their immediate parent companies. Furthermore, in the case of Lloyds Banking Group plc, dividends may only be paid if sufficient distributable profits are available for distributions due in the financial year on certain preferred securities. The board has the discretion to decide whether to pay a dividend and the amount of any dividend. In making this decision, the board is mindful of the level of dividend cover and, consequently, profit growth may not necessarily result in increases in the dividend. The board recognises the importance attached by shareholders to the Company's dividend. In the case of American Depositary Shares, dividends are paid through The Bank of New York Mellon which acts as paying and transfer agent.

The table below sets out the interim and final dividends which were declared in respect of the ordinary shares for fiscal years 2003 through 2010. The sterling amounts have been converted into US dollars at the Noon Buying Rate in effect on each payment date.

	Interim dividend per share (£)	Interim dividend per share (\$)	Final dividend per share (£)	Final dividend per share (\$)
2003	0.107	0.178	0.235	0.421
2004	0.107	0.190	0.235	0.447
2005	0.107	0.189	0.235	0.433
2006	0.107	0.202	0.235	0.468
2007	0.112	0.228	0.247	0.482
2008	0.114	0.203		
2009				
<b>2010</b>				

## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

A summary of the material provisions of Lloyds Banking Group plc's memorandum and articles of association is set out below. This is unchanged from the summary that was incorporated into Lloyds Banking Group plc's annual report on Form 20-F for the year ended 31 December 2009 filed with the SEC on 13 May 2010.

Lloyds Banking Group plc is incorporated in Scotland under the UK Companies Act 1985 with registered number SC95000.

As resolved at the 2009 Annual General Meeting and in accordance with changes in UK company law with effect from 1 October 2009, Lloyds Banking Group plc deleted all provisions of its Memorandum of Association which, by virtue of Section 28 of the Companies Act 2006 (the Companies Act), are to be treated as part of the Articles of Association, including those provisions dealing with the Company's objects.

### OBJECTS OF LLOYDS BANKING GROUP PLC

As permitted under recent changes in UK company law, the objects of Lloyds Banking Group plc are unrestricted.

### VOTING RIGHTS

For the purposes of determining which persons are entitled to attend or vote at a meeting and how many votes such persons may cast, Lloyds Banking Group plc may specify in the notice of the meeting a time, not more than 48 hours before the time fixed for the meeting, by which a person must be entered on the register in order to have the right to attend or vote at the meeting. Every holder of ordinary shares who is entitled to be and is present in person (including any corporation by its duly authorised representative) at a general meeting of Lloyds Banking Group plc and is entitled to vote will have one vote on a show of hands and, on a poll, if present in person or by proxy, will have one vote for every such share held by him, save that a member will not be entitled to exercise the right to vote carried by such shares if he or any person appearing to be interested in the shares held by him has been duly served with a notice under section 793 of the Companies Act (requiring disclosure of interests in shares) and is in default in supplying Lloyds Banking Group plc with information required by such notice. The limited voting shares confer the right to receive notice of and to attend and speak at all general meetings of Lloyds Banking Group plc, but do not confer a right to vote unless the business of the meeting includes the consideration of a resolution:

to approve an acquisition or disposal by Lloyds Banking Group plc or any of its subsidiaries in circumstances in which the approval of shareholders in general meeting is either required by virtue of securities of Lloyds Banking Group plc being listed on a recognised exchange, or is sought by the directors, due to the significance of the transaction; or

for the winding-up of Lloyds Banking Group plc; or

to vary the rights of the limited voting shares.

In any such case, the holder may vote the limited voting shares only in respect of such resolution and will have the same rights with regard to the number and exercise of votes as a holder of ordinary shares but, in the case of a variation in the rights of limited voting shares, shall also have the protection of a requirement for approval of the variation by way of a special resolution at a separate class meeting of the holders of limited voting shares. Preference shares confer such rights as may be determined by the directors on allotment, but unless the directors otherwise determine, fully paid preference shares confer identical rights as to voting, capital dividends and otherwise, notwithstanding that they are denominated in different currencies and shall be treated as if they are one single class of shares. There are no limitations imposed by UK law or the Articles of Association of Lloyds Banking Group plc restricting the rights of non-residents of the UK or non-citizens of the UK to hold or vote shares of Lloyds Banking Group plc.

### GENERAL MEETINGS

Lloyds Banking Group plc must give at least 21 days' notice in writing of an annual general meeting. All other general meetings may be called by at least 14 days' notice in writing. The directors may make arrangements to regulate the level of attendance at any place specified for the holding of a general meeting and, in any such case, shall direct that the meeting be held at a specified place, where the chairman of the meeting shall preside, and make arrangements for simultaneous attendance and participation by members and proxies at other locations. The chairman of a general meeting has express authority to adjourn the meeting if, in his opinion, it appears impracticable to hold or continue the meeting because of crowding or unruly conduct or because an adjournment is otherwise necessary for the proper conduct of the meeting. Annual general meetings of Lloyds Banking Group plc are to be held in Edinburgh or such other place in Scotland as the directors shall appoint.

**DIVIDENDS AND OTHER DISTRIBUTIONS AND RETURN OF CAPITAL**

The shareholders in general meeting may by ordinary resolution declare dividends to be paid to members of Lloyds Banking Group plc, but no dividends shall be declared in excess of the amount recommended by the directors. The directors may pay fixed dividends on any class of shares carrying a fixed dividend and may also from time to time pay dividends, interim or otherwise, on shares of any class. Except in so far as the rights attaching to any shares otherwise provide, all dividends shall be apportioned and paid *pro rata* according to the amounts paid up thereon. Subject to the rights attaching to any shares, any dividend or other monies payable in respect of a share may be paid in such currency or currencies as the directors may determine using such exchange rates as the directors may select.

The opportunity to elect to receive new shares instead of any cash dividend recommended by the directors, may be offered to shareholders provided that the directors shall have obtained in advance the shareholders' approval to do so as required by the Articles of Association.

## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

The limited voting shares do not confer a right to participate in any distribution of profits by way of dividend. For any other distributions, the limited voting shares shall be deemed to confer rights and interests in the profits equally with the holders of ordinary shares according to the amounts paid up on such limited voting shares and ordinary shares respectively otherwise than in advance of calls.

On any distribution by way of capitalisation, the amount to be distributed will be appropriated amongst the holders of ordinary shares and limited voting shares in proportion to their holdings of ordinary shares and limited voting shares (*pro rata* to the amount paid up thereon). If the amount to be distributed is applied in paying up in full unissued ordinary shares and limited voting shares of Lloyds Banking Group plc, a shareholder will be entitled to receive bonus shares of the same class as the shares giving rise to his entitlement to participate in the capitalisation.

Any dividend unclaimed after a period of 12 years from the date of declaration of such dividend will be forfeited and revert to Lloyds Banking Group plc. No dividends or other monies payable on or in respect of a share shall bear interest against Lloyds Banking Group plc.

On a return of capital, whether in a winding-up or otherwise, the ordinary shares and the limited voting shares will rank equally in all respects and the preference shares will be entitled to the rights attaching to them on issue.

### CONVERSION OF LIMITED VOTING SHARES

Each limited voting share will be converted into an ordinary share:

on the day following the last date on which an amount could become due and payable to a holder of limited voting shares under a deed of covenant in favour of the Lloyds TSB Foundations. A deed of covenant is a legal document which records the obligation of one person to pay a specified sum to another for a specified number of years; or

if an offer is made to shareholders (or to all such shareholders other than the offeror and/or any body corporate controlled by the offeror and/or any persons acting in concert with the offeror) to acquire the whole or any part of the issued ordinary share capital of Lloyds Banking Group plc and the right to cast more than 50 per cent of the votes which may ordinarily be cast on a poll at a general meeting of Lloyds Banking Group plc becomes or is certain to become vested in the offeror and/or any bodies corporate controlled by the offeror and/or any persons acting in concert with the offeror. The publication of a scheme of arrangement under the statutes providing for the acquisition by any person of the whole or part of the ordinary share capital of Lloyds Banking Group plc shall be deemed to be the making of an offer for this purpose.

The ordinary shares resulting from conversion will carry the right to receive all dividends and other distributions declared, made or paid on the ordinary share capital of Lloyds Banking Group plc by reference to a record date on or after the date of conversion and will rank equally in all other respects and form one class with the ordinary share capital of Lloyds Banking Group plc then in issue and fully paid.

Holders of limited voting shares will be entitled to participate in any offer made by way of rights to holders of ordinary shares as if the limited voting shares had been converted at the relevant record date.

### VARIATION OF RIGHTS AND ALTERATION OF CAPITAL

Subject to the provisions of the Companies Act, the CREST Regulations and every other statute for the time being in force or any judgment or order of any court of competent jurisdiction concerning companies and affecting Lloyds Banking Group plc (the statutes), the rights attached to any class of shares for the time being in issue may (subject to their terms of issue) be varied, modified or abrogated with the consent in writing of the holders of not less than three-quarters in nominal value of the issued shares of that class or with the sanction of a special resolution passed at a separate meeting of the holders of shares of that class. At any such separate meeting, the provisions of the Articles of Association relating to general meetings will apply, but the necessary quorum at any such meeting will be two persons holding or representing by proxy at least one-third in nominal value of the issued shares of that class (except at an adjourned meeting, at which the quorum shall be any holder of shares of the class, present in person or by proxy) and any such person may demand a poll.

However, for so long as the limited voting shares have not been converted (as described above):

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Lloyds Banking Group plc is prohibited from consolidating or subdividing any of the ordinary shares without consolidating or subdividing the limited voting shares in a like manner and to a like extent; and

Lloyds Banking Group plc will not create any new class of equity share capital, other than in connection with or pursuant to an employees' share scheme approved by Lloyds Banking Group plc in general meeting, provided that the creation of equity share capital which carries (as compared with the Existing Ordinary Shares) only restricted voting or no voting rights and no greater rights as regards dividends or capital shall not be deemed to be the creation of a new class of equity share capital. As a matter of UK law, Lloyds Banking Group plc may, by ordinary resolution, increase its share capital, consolidate and divide all or any of its shares into shares of larger amount, sub-divide all or any of its shares into shares of smaller amount and cancel any shares not taken or agreed to be taken by any person.

Subject to the provisions of the statutes, Lloyds Banking Group plc may, by special resolution, reduce its share capital, any capital redemption reserve, share premium account or other undistributable reserve in any way.

### **TRANSFER OF SHARES**

All transfers of shares which are in certificated form may be effected by transfer in writing in any usual or common form or in any other form acceptable to the directors and must be executed by or on behalf of the transferor and, if the shares thereby transferred are not fully paid, by or on behalf of the transferee. The transferor will be deemed to remain the holder of the shares transferred until the name of the transferee is entered in the register of members of Lloyds Banking Group plc in respect thereof. All transfers of shares which are in uncertificated form may be effected by means of a relevant system.

The directors may, in the case of shares in certificated form, in their absolute discretion and without assigning any reason therefor, refuse to register any transfer of shares (not being fully paid shares) provided that, where any such shares are admitted to the Official List of the UK Financial Services Authority, such discretion may not be exercised in such a way as to prevent dealings in the shares of that class from taking place on an open and proper basis. The directors may also decline to register a transfer unless either:

the instrument of transfer complies with the requirements of the Articles of Association and the transfer is in respect of only one class of shares; or

the transfer is in favour of not more than four persons as the transferee.



## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

The directors shall refuse to register the transfer of any share on which Lloyds Banking Group plc has a lien and shall refuse to register the transfer of any limited voting share unless the same is:

between existing holders of limited voting shares; or

under a scheme established or order made by the Charity Commissioners or by the Court to a transferee having charitable objects; or

in the course of a winding-up to an institution having charitable objects which prohibit distributions of income and property to members to at least the same extent as is imposed on the transferor by its Memorandum of Association; or

at the direction of the crown to another charity having similar objects.

The Articles of Association otherwise contain no restrictions on the free transferability of fully paid shares.

Lloyds Banking Group plc's shares are in registered form and the Articles of Association do not provide for bearer shares. The registration of share transfers may be suspended and the register may be closed at such times and for such periods as the directors may determine (not exceeding 30 days in any year), provided that if the shares are traded through an electronic trading system, the register may not be closed without the consent of the operator.

Subject to the statutes and the rules (as defined in the CREST Regulations), the directors may determine that any class of shares may be held in uncertificated form and that title to such shares may be transferred by means of an electronic trading system or that shares of any class should cease to be so held and so transferred.

### **DISCLOSURE OF HOLDINGS EXCEEDING CERTAIN PERCENTAGES**

The Disclosure and Transparency Rules of the UK Financial Services Authority require Lloyds Banking Group plc shareholders to notify Lloyds Banking Group plc if the voting rights held by such Lloyds Banking Group plc shareholders (including by way of a certain financial instrument) reach, exceed or fall below 3 per cent and each 1 per cent threshold thereafter up to 100 per cent. Under the Disclosure and Transparency Rules, certain voting rights in Lloyds Banking Group plc may be disregarded.

Pursuant to the Companies Act, Lloyds Banking Group plc may also send a notice to any person whom Lloyds Banking Group plc knows or believes to be interested in Lloyds Banking Group plc's shares, requiring that person to confirm whether he has such an interest and if so details of that interest.

Under the Articles of Association and UK law, if a person fails to comply with such a notice or provides information that is false in a material particular in respect of any shares (the default shares), the Lloyds Banking Group plc directors may serve a restriction notice on such a person. Such a restriction notice will state that the default shares and, if the Lloyds Banking Group plc directors determine, any other shares held by that person, shall not confer any right to attend or vote at any general meeting of Lloyds Banking Group plc.

In respect of a person with a 0.25 per cent or more interest in the issued shares of the class in question, the Lloyds Banking Group plc directors may direct by notice to such member that, subject to certain exceptions, no transfers of shares held by such person shall be registered and that any dividends or other payments on the shares shall be retained by Lloyds Banking Group plc pending receipt by Lloyds Banking Group plc of the information requested by the Lloyds Banking Group plc directors. Certain consequences of the issue of a restriction notice are outlined above.

### **MANDATORY TAKEOVER BIDS, SQUEEZE-OUT AND SELL-OUT RULES**

Other than as provided by the Companies Act and the City Code, there are no rules or provisions relating to mandatory bids and/or squeeze-out and sell-out rules in relation to the ordinary shares.

### **UNTRACED MEMBERS**

Lloyds Banking Group plc is empowered to sell, as the agent of a member, at the best price reasonably obtainable, any share registered in the name of a member remaining untraced for 12 years who fails to communicate with Lloyds Banking Group plc within three months following the publication of an advertisement of an intention to make such a disposal; provided that during the

12-year period at least three dividends have become payable and no dividend has been claimed.

Lloyds Banking Group plc shall be obliged to account to the member for the proceeds of the disposal. However, any net proceeds of sale unclaimed after 12 years from the date of sale shall be forfeited and shall revert to Lloyds Banking Group plc.

#### **FORFEITURE AND LIEN**

If a member fails to pay in full any call or instalment of a call on or before the due date for payment, then, following notice by the directors requiring payment of the unpaid amount with any accrued interest and any expenses incurred, such share may be forfeited by a resolution of the directors to that effect (including all dividends declared in respect of the forfeited share and not actually paid before forfeiture). A member whose shares have been forfeited will cease to be a member in respect of the shares, but will, notwithstanding the forfeiture, remain liable to pay to Lloyds Banking Group plc all monies which at the date of forfeiture were presently payable together with interest. The directors may at their absolute discretion enforce payment without any allowance for the value of the shares at the time of forfeiture or for any consideration received on their disposal or waive payment in whole or part.

Lloyds Banking Group plc has a first and paramount lien on every share (not being a fully paid share) for all monies (whether presently payable or not) called or payable at a fixed time in respect of such share, and the directors may waive any lien which has arisen and may resolve that any share shall for some limited period be exempt from such a lien, either wholly or partially.

A forfeited share becomes the property of Lloyds Banking Group plc, and it may be sold, re-allotted, otherwise disposed of or cancelled as the directors see fit. Any share on which Lloyds Banking Group plc has a lien may be sold on the terms set out in the Articles of Association. The proceeds of sale shall first be applied towards payment of the amount in respect of the lien insofar as it is still payable and then on surrender of the share certificate for cancellation (in the case of shares in certificated form), to the person entitled to the shares at the time of sale.

## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

### **WINDING-UP**

If Lloyds Banking Group plc is wound up, the liquidator may, with the authority of a ordinary resolution, divide amongst the members in specie or kind the whole or any part of the assets of Lloyds Banking Group plc. The liquidator may for such purpose set such value as he deems fair upon any one or more class or classes of property and may determine how such division shall be carried out as between the members or different classes of members. The liquidator may vest any part of the assets in trustees upon such trusts for the benefit of members as the liquidator thinks fit, and the liquidation may be closed and Lloyds Banking Group plc dissolved, but so that no contributory shall be compelled to accept any shares or other property in respect of which there is a liability.

### **DIRECTORS**

The business and affairs of Lloyds Banking Group plc shall be managed by the directors, who may exercise all such powers of Lloyds Banking Group plc as are not by the statutes or by the Articles of Association required to be exercised by Lloyds Banking Group plc in general meeting, subject to the Articles of Association, to the provisions of the statutes and to such regulations as may be set by special resolution of Lloyds Banking Group plc, but no regulation so made by Lloyds Banking Group plc will invalidate any prior act of the directors which would have been valid if such regulation had not been made.

The directors may confer upon any director holding any executive office any of the powers exercisable by them on such terms and conditions, and with such restrictions, as they think fit. The directors may also delegate any of their powers to committees. Any such committee shall have power to sub-delegate to sub-committees or to any person any of the powers delegated to it. Any such committee or sub-committee shall consist of one or more directors only. The meetings and proceedings of any such committee or sub-committee consisting of two or more persons shall be governed, with such changes as are appropriate, by the provisions of the Articles of Association regulating the meetings and proceedings of the directors.

The quorum necessary for the transaction of business of the directors may be fixed from time to time by the directors and unless so fixed at any other number shall be four. Questions arising at any meeting of the directors shall be determined by a majority of votes. In the case of an equality of votes, the chairman of the meeting shall have a second or casting vote.

### **DIRECTORS RETIREMENT**

The Articles of Association provide that each director shall retire at the annual general meeting held in the third calendar year following the year in which he was elected or last re-elected.

### **DIRECTORS SHARE QUALIFICATION**

A director is not required to hold any shares of Lloyds Banking Group plc by way of qualification.

### **DIRECTORS INDEMNITY/INSURANCE**

So far as may be permitted by the statutes, any person who is or was at any time a director, officer, employee or trustee of Lloyds Banking Group plc (or any associated company) may be indemnified by Lloyds Banking Group plc against any liability incurred by him in connection with any negligence, default, breach of duty or breach of trust by him or any other liability incurred in the execution of his duties, the exercise of his powers or otherwise in connection with his duties, powers or offices. The directors of Lloyds Banking Group plc may also purchase and maintain insurance in respect of such liabilities. So far as may be permitted by the statutes, Lloyds Banking Group plc may also provide defence costs in relation to any criminal, civil or regulatory proceedings to which any current or former director, officer, employee or trustee of Lloyds Banking Group plc (or any associated company) is subject and do anything to enable any such a person to avoid incurring such expenditure.

### **AUTHORISATION OF DIRECTORS INTERESTS**

Subject to the provisions of the statutes, the directors can authorise any matter which would or might otherwise constitute or cause a breach of the duty of a director to avoid a situation in which he has or can have a direct or indirect interest that conflicts, or may reasonably be expected at the time of authorisation to be a situation in which he has or can have a conflict, with the interests of Lloyds Banking Group plc.

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Such authorisation of a matter shall be effective only if the matter in question shall have been proposed in writing for consideration at a meeting of the directors, in accordance with the board's normal procedures, or in such other manner as the directors may determine.

Any authorisation of a matter under the Articles of Association shall be subject to such conditions or limitations as the directors may determine, whether at the time such authorisation is given or subsequently, and may be terminated by the directors at any time. A director shall comply with any obligations imposed on him pursuant to any such authorisation.

A director shall not, save as otherwise agreed by him, be accountable to Lloyds Banking Group plc for any benefit which he (or a person connected with him) derives from any matter authorised by the directors and any contract, transaction or arrangement relating thereto shall not be liable to be avoided on the grounds of any such benefit.

Where a director has an interest which can reasonably be regarded as likely to give rise to a conflict of interest, the director may, and shall if so requested by the directors, take such additional steps as may be necessary or desirable for the purpose of managing such conflict of interest, including compliance with any procedures laid down from time to time by the directors.

Lloyds Banking Group plc may by ordinary resolution ratify any contract, transaction or arrangement, or other proposal, not properly authorised under the Articles of Association.

MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

**MATERIAL INTERESTS**

Subject to the provisions of the statutes, the director (or a person connected with him), provided that the director has declared the nature and extent of any interest as required under the Articles of Association:

may be a director or other officer of, or be employed by, or otherwise interested (including by the holding of shares) in Lloyds Banking Group plc, a subsidiary undertaking of Lloyds Banking Group plc, any holding company of Lloyds Banking Group plc, a subsidiary undertaking of any such holding company, or any body corporate promoted by Lloyds Banking Group plc or in which Lloyds Banking Group plc is otherwise interested (a relevant company);

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