Lloyds Banking Group plc
Form 20-F
May 07, 2009

As filed with the Securities and Exchange Commission on 7 May 2009

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

FORM 20-F

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

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended 31 December 2008

OR

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

OR

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

Commission file number 001-15246

LLOYDS BANKING GROUP plc

(previously Lloyds TSB Group plc)
(Exact name of Registrant as Specified in Its Charter)
Scotland
(Jurisdiction of Incorporation or Organization)

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

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

Title of each class	**Name of each exchange on which registered**
Ordinary shares of nominal value 25 pence each, represented by American Depositary Shares.	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 2008 was:

Ordinary shares, nominal value 25 pence each, as of 31 December 2008	5,972,855,669
Limited voting shares, nominal value 25 pence each, as of 31 December 2008	78,947,368
Preference shares, nominal value 25 pence each, as of 31 December 2008	600,400
Preference shares, nominal value 25 cents each, as of 31 December 2008	1,000,000
Preference shares, nominal value 25 euro cents each, as of 31 December 2008	0
Preference shares, nominal value Japanese ¥25 each, as of 31 December 2008	0

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

Yes x No o

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

Yes o No x

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

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

Yes x No o

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

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

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

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

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

Item 17 o Item 18 o

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

Yes o No x

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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, 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).

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 2008, which was $1.4619 = £1.00. The Noon Buying Rate on 31 December 2008 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, whose businesses provide a wide range of banking and financial services in the UK and a limited number of locations overseas. At 31 December 2008, total Lloyds Banking Group assets were £436,033 million and Lloyds Banking Group had some 59,000 employees (on a full-time equivalent basis). Lloyds Banking Group plc s market capitalisation at that date was some £7,500 million. The profit before tax for the 12 months to 31 December 2008 was £807 million and the risk asset ratios as at that date were 11.2 per cent for total capital and 8.0 per cent for tier 1 capital.

In 2008, the operations of Lloyds Banking Group in the UK were conducted through over 1,950 branches of Lloyds TSB Bank, Lloyds TSB Scotland plc and Cheltenham & Gloucester plc. As described on page 6, Cheltenham & Gloucester plc (C&G) was the Group s specialist mortgage arranger. Following the transfer of its mortgage lending and deposits to Lloyds TSB Bank during 2007, C&G now arranges mortgages for Lloyds TSB Bank rather than for its own account. In 2008, international business was conducted mainly in the US and continental Europe, and the Group s services in these countries were offered largely through branches of Lloyds TSB Bank. Lloyds Banking Group also offered offshore banking facilities in a number of countries. For additional information see Regulation .

At 31 December 2008, Lloyds Banking Group s activities were organised into three divisions: UK Retail Banking, Insurance and Investments, and Wholesale and International Banking. Services provided by UK Retail Banking included the provision of banking and other financial services to personal customers, private banking and mortgages. Insurance and Investments offered life assurance, pensions and investment products, general insurance and fund management services. Wholesale and International Banking provided banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provided asset finance to personal and corporate customers, managed Lloyds Banking Group s activities in financial markets through its treasury function and provided banking and financial services overseas.

The following table shows the results of Lloyds Banking Group s UK Retail Banking, Insurance and Investments and Wholesale and International Banking segments and Central group items in each of the last three fiscal years. In order to provide a more comparable representation of business performance volatility (see Operating and financial review and prospects Line of business information Volatility , for a description of volatility, its significant limitations and the processes put in place by management to compensate for these limitations) has been separately analysed from the results of the individual business units so that, where appropriate, information is presented both in accordance with applicable accounting standards (statutory) and on a basis which excludes volatility (excluding volatility).

	Profit before tax (statutory)			**Profit before tax (excluding volatility)**		
	2008	2007#	2006#	**2008**	2007#	2006#
	£m	£m	£m	**£m**	£m	£m
UK Retail Banking	**1,674**	1,644	1,529	**1,674**	1,644	1,529
Insurance and Investments	**(309)**	655	1,194	**908**	1,155	784
Wholesale and International Banking	**(6)**	1,713	1,612	**(6)**	1,713	1,612
Central group items	**(552)**	(12)	(87)	**(552)**	(12)	(87)
Profit before tax, excluding volatility				**2,024**	4,500	3,838
Volatility*				**(1,217)**	(500)	410
Profit before tax	**807**	4,000	4,248	**807**	4,000	4,248

* Volatility relates to Insurance and Investments.

\# As part of Lloyds Banking Group s transition to Basel II on 1 January 2008, the Group has updated its capital and liquidity pricing methodology. The main difference in this approach is to allocate a greater share of certain funding costs, previously allocated to the Central group items segment, to the other divisions. To enable meaningful year-on-year comparisons, the segmental analyses for 2007 and 2006 have been restated to reflect these changes.

On 16 January 2009, Lloyds TSB Group plc acquired 100 per cent of the ordinary share capital of HBOS plc which, together with its subsidiaries and associated undertakings, undertakes banking, insurance and other financial services related activities. Following the acquisition, the Company changed its name to Lloyds Banking Group plc.

On 7 March 2009, the Company announced that it intends to participate in the UK Government s Asset Protection Scheme (GAPS), with the intention of reducing its risk-weighted assets and strengthening the Group s capital position (see Recent Developments UK Government Asset Protection Scheme).

Lloyds Banking Group plc (previously Lloyds TSB 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 Henry Duncan House, 120 George Street, Edinburgh EH2 4LH, 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 four years adjusted for subsequent changes in accounting policy and presentation. These tables have been prepared in accordance with IFRS. The financial statements for each of the years 2004 to 2008 have been audited by PricewaterhouseCoopers LLP, independent accountants.

	2008	2007	2006	2005	2004[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**9,872**	10,706	11,104	10,540	9,661
Operating expenses	**(6,053)**	(5,567)	(5,301)	(5,471)	(5,297)
Trading surplus	**3,819**	5,139	5,803	5,069	4,364
Impairment losses	**(3,012)**	(1,796)	(1,555)	(1,299)	(866)
Profit before tax	**807**	4,000	4,248	3,820	3,477
Profit for the year	**845**	3,321	2,907	2,555	2,459
Profit for the year attributable to equity shareholders	**819**	3,289	2,803	2,493	2,392
Total dividend for the year[2]	**648**	2,026	1,928	1,915	1,914
Balance sheet data at 31 December (£m)					
Share capital	**1,513**	1,432	1,429	1,420	1,419
Shareholders equity	**9,393**	12,141	11,155	10,195	11,047
Customer accounts	**170,938**	156,555	139,342	131,070	119,811
Preferred securities	**5,496**	3,031	2,957	2,549	1,388
Undated subordinated liabilities	**5,638**	4,869	4,863	5,184	4,464
Dated subordinated liabilities	**6,122**	4,058	4,252	4,669	4,400
Loans and advances to customers	**242,735**	209,814	188,285	174,944	155,318
Total assets	**436,033**	353,346	343,598	309,754	284,422
Share information					
Basic earnings per ordinary share	**14.3p**	58.3p	49.9p	44.6p	42.8p
Diluted earnings per ordinary share	**14.2p**	57.9p	49.5p	44.2p	42.5p
Net asset value per ordinary share	**155p**	212p	195p	180p	195p
Total dividend per ordinary share[2]	**11.4p**	35.9p	34.2p	34.2p	34.2p
Equivalent cents per share[2,3]	**20.3c**	71.0c	67.0c	62.2c	63.7c
Market price per ordinary share (year end)	**126p**	472p	571.5p	488.5p	473p
Number of shareholders (thousands)	**824**	814	870	920	953
Number of ordinary shares in issue (millions)[4]	**5,973**	5,648	5,638	5,603	5,596
Financial ratios (%)[5]					
Dividend payout ratio	**79.1**	61.6	68.8	76.8	80.0
Post-tax return on average shareholders equity	**7.4**	28.2	26.6	25.6	22.8
Post-tax return on average assets	**0.22**	0.94	0.88	0.84	0.92
Average shareholders equity to average assets	**2.9**	3.3	3.2	3.2	3.9
Cost:income ratio[6]	**61.3**	52.0	47.7	51.9	54.8
Capital ratios (%)[7]					
Total capital	**11.2**	11.0	10.7	10.9	10.1
Tier 1 capital	**8.0**	8.1	8.2	7.9	8.2

1 Except for capital ratios (see 7 below), comparative data for 2004 excludes the provisions of IAS 32, IAS 39 and IFRS 4, which were adopted with effect from 1 January 2005.

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

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

4 This figure excludes the 79 million limited voting ordinary shares owned by the Lloyds TSB Foundations.

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

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

7 In order to provide a more meaningful comparison, capital ratios are shown at 1 January 2005, rather than 31 December 2004, in order to reflect the application of those accounting standards applied with effect from 1 January 2005. Capital ratios for 2008 are in accordance with Basel II requirements; ratios for 2007 and earlier years reflect Basel I.

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:

	2009 March	2009 February	2009 January	2008 December	2008 November	2008 October
US dollars per pound sterling:						
High	1.47	1.49	1.53	1.55	1.62	1.78
Low	1.38	1.42	1.37	1.44	1.48	1.55

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:

	2008	2007	2006	2005	2004
US dollars per pound sterling:					
Average	1.84	2.01	1.86	1.81	1.84

On 17 April 2009, the latest practicable date, the US dollar Noon Buying Rate was $1.4778 = £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 Lloyds Banking 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.

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 renamed 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.

Since August 2007 and even more so since September 2008, global financial markets have experienced a period of significant turmoil, which, among other things, included the UK Government placing Northern Rock into temporary public ownership on 22 February 2008 and the announcement on 15 September 2008 by Lehman Brothers that it intended to file a Chapter 11 bankruptcy petition in the United States. On 18 September 2008, with the support of the UK Government, the boards of the Company and HBOS plc announced that they had reached agreement on the terms of a recommended acquisition by the Company of HBOS plc. The shareholders of the Company approved the acquisition at the Company s general meeting on 19 November 2008 and the acquisition was completed on 16 January 2009. Following the acquisition, the Company changed its name to Lloyds Banking Group plc and operates its business through two significant subsidiaries, Lloyds TSB Bank plc and HBOS plc.

Pursuant to the placing and open offer by Lloyds Banking Group plc which was completed in January 2009 (and the concomitant placing and open offer by HBOS) and the acquisition of HBOS by Lloyds Banking Group plc completed on 16 January 2009, the UK Government acquired 43.38 per cent of the Company s issued ordinary share capital. See Major Shareholders and Related Party Transactions Information about the Lloyds Banking Group s relationship with the UK Government for a description of the Group s relationship with the UK Government.

STRATEGY OF LLOYDS BANKING GROUP

Since 2003 the Group strategy has focused on:

- enhancing the quality of its earnings by exiting businesses which were not regarded as core or which added unnecessary volatility to its earnings;
- accelerating growth by deepening customer relationships and improving productivity and, in the process, building competitive advantage through enhancing capabilities; and
- taking advantage of opportunities to grow inorganically to complement the Group s organic strategies and help provide new opportunities for profitable growth.

In keeping with this strategy, the Group completed the acquisition of HBOS on 16 January 2009. The Group had long recognised the attractions of a combination of Lloyds and HBOS and believes that the acquisition represents a compelling opportunity to reinforce the strategy and create the UK s leading financial services group. Furthermore, the directors believe that the Lloyds Banking Group will be more competitive and better placed in a rapidly evolving UK banking industry than either organisation would have been on a stand-alone basis.

MARKETS

Lloyds Banking Group continues to focus on building competitive advantage in its core markets by seeking opportunities to consolidate its position in businesses where it is already strong and by divesting businesses in markets where it is not a leader and cannot aspire reasonably to leadership.

BUSINESS

The board believes that the UK remains an attractive market and that the Group has good potential within its existing franchises to grow by meeting more of the Group s customers needs as well as through adding new customers to the franchise, notwithstanding near term economic conditions (see Risk Factors Business and Economic Risks The Group s businesses are subject to inherent risks arising from general and sector-specific economic conditions in the UK and other markets in which it operates. Adverse developments, such as the current and ongoing crisis in the global financial markets, recession, and further deterioration of general economic conditions, particularly in the UK, have already adversely affected the Group s earnings and profits and could continue to cause its earnings and profitability to decline for a discussion of such economic conditions).

STRATEGY

The Lloyds Banking Group vision is to be recognised as the best financial services organisation in the UK by customers, colleagues (employees) and shareholders.

The strategy for the Group remains to grow the business through developing long-term relationships and building its customer franchise, and its focus remains within the UK; the Group s position in this regard was strengthened through the acquisition of HBOS in January 2009. All the Group s businesses are focused on extending the reach and depth of the Group s customer relationships, whilst enhancing product capabilities to build competitive advantage. A prudent through the cycle approach to risk is being applied to the Group and will remain important as the Group strives to improve its processing efficiency and use of capital.

The integration with HBOS presents an opportunity to achieve both customer and cost leadership through leveraging the best heritage Lloyds TSB and HBOS capabilities across the combined franchise and realising integration synergies. The board believes that Lloyds Banking Group has market leading distribution and sales capabilities, products and services as well as middle and back office processes that deliver a high quality customer experience. The Group aspires to have one of the lowest cost: income ratios for financial institutions in the UK, and the anticipated synergies, which are expected to be substantial, arising from the acquisition of HBOS will be key to further improving efficiency levels. The effective integration of the two businesses will be a significant challenge over the next few years, but the combination of the two businesses provides a real opportunity to create the UK s leading financial services organisation.

During 2008, the Group had three primary operating divisions: UK Retail Banking; Insurance and Investments; and Wholesale and International Banking. The key product markets in which these divisions participate is presented in Businesses and Activities of Lloyds Banking Group and an analysis of their performance in 2008 and 2007 is included within the Operating and financial review and prospects . Following the acquisition of HBOS these divisions will be restructured with elements from some existing businesses coming together to form another division. The new Wealth and International division has been created to focus on Wealth Management, Asset Management and International Banking.

Since August 2007, global financial markets have experienced a period of significant turmoil resulting in a negative impact on capital ratios and liquidity in the banking sector. Throughout this period, the Group has maintained a robust liquidity position based on its significant retail and corporate deposit base and funding from the wholesale markets. Since the completion of the HBOS acquisition, the Group has continued to fund itself in the wholesale markets at rates comparable to the period prior to completion. In addition, the Group has continued to reinforce its funding position by actively participating in the support initiatives introduced by the Bank of England and HM Treasury. Participation in the UK Government backed provision of liquidity required Lloyds and HBOS to raise additional capital; as a result of the common equity subscribed to by the UK Government, the UK Government has a 43.38 per cent shareholding in the Company and also holds £4,000 million in preference shares.

The Group believes that a strong capital position will position it to face the severest of economic downturns and emerge strongly when the economy recovers. It therefore decided, as announced on 7 March 2009, to participate in the UK Government s Asset Protection Scheme (GAPS) with the intention of substantially reducing its risk-weighted assets and very significantly strengthening its capital position. Further details of this arrangement, which is currently being negotiated, are set out in Recent Developments and a discussion of the consequences of not acceding to the GAPS is set out in Risk Factors Government-related Risks If Lloyds Banking Group is unable to participate in the GAPS, or the operation of the GAPS fails to have the desired effect on Lloyds Banking Group s financial and capital position, or the costs of participation outweigh the benefits, this could have a material adverse effect on the Group s results of operations, financial condition and prospects .

Lloyds Banking Group s directors believe that the heritage Lloyds TSB Group relationship-focused through the cycle approach to risk management has demonstrated its effectiveness. This prudent approach to risk is being rolled out across the combined Lloyds Banking Group. The new Group has already exited a number of non-core areas in which HBOS previously participated and will continue to assess participation in business areas on a conservative basis.

The Group is a business based on building strong and long-lasting relationships through the efforts of its people. Colleagues are the Group s most valuable resource. It is the Group s colleagues who build long-lasting relationships with its customers and, therefore, managing the Group s colleagues effectively is fundamental to the success of the business and achieving the Group s vision of being the best financial services organisation in the UK.

By creating a great place to work, the Group believes it will attract the highest performing people and secure the commitment of those who are the strongest performers and have the highest potential to remain with the Group.

SUMMARY

The Group believes that the successful execution of this strategy focusing on core markets, customer and cost leadership, capital efficiency and a prudent risk appetite should enable the Lloyds Banking Group to achieve its vision to be recognised as the best financial services organisation in the UK.

BUSINESS

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

At 31 December 2008, Lloyds Banking Group s activities were organised into three divisions: UK Retail Banking, Insurance and Investments, and Wholesale and International Banking. The main activities of these divisions at 31 December 2008 were as described below.

UK RETAIL BANKING

During 2008, UK Retail Banking provided banking, financial services, mortgages and private banking to some 16 million personal customers through the Group s multi-channel distribution capabilities.

Branches. The Group provided wide-reaching geographic branch coverage in England, Scotland and Wales, through over 1,950 branches of Lloyds TSB Bank, Lloyds TSB Scotland plc (Lloyds TSB Scotland) and C&G.

Internet banking. Internet banking provided online banking facilities for personal customers. At the end of 2008, some 5.2 million customers had registered to use the Group s internet banking services, and were conducting more than 79 million actions per month online, an 11 per cent increase on 2007.

Telephone banking. Telephone banking continues to grow. At the end of 2008, some 5.7 million customers had registered to use the services of PhoneBank and the automated voice response service, PhoneBank Express. The Group s telephone banking centres handled some 71 million calls during 2008.

Cash machines. The Group has one of the largest cash machine networks of any leading banking group in the UK and, at 31 December 2008, personal customers of Lloyds TSB Bank and Lloyds TSB Scotland were able to withdraw cash and check balances through over 4,200 ATMs at branches and external locations around the UK. In addition, at 31 December 2008, UK Retail Banking s personal customers had access to over 63,000 cash machines via LINK in the UK and to cash machines worldwide through the VISA and MasterCard networks.

Current accounts. Lloyds TSB Bank and Lloyds TSB Scotland offer a wide range of current accounts, including interest-bearing current accounts and a range of added-value accounts.

Savings accounts. Lloyds TSB Bank and Lloyds TSB Scotland offer a wide range of savings accounts and retail investments.

Personal loans. Lloyds TSB Bank and Lloyds TSB Scotland offer a range of personal loans.

Cards. The Group provides a range of card-based products and services, including credit and debit cards and card transaction processing services for retailers. The Group is a member of both the VISA and MasterCard payment systems and has access to the American Express payment system.

Mortgages. In 2008 C&G was Lloyds specialist residential mortgage arranger, offering a range of mortgage products to personal customers through its own branches and those of Lloyds TSB Bank in England and Wales, as well as through the telephone, internet and postal service, Mortgage Direct. The Group also provided mortgages through Lloyds TSB Scotland and Scottish Widows Bank. The Group is one of the largest residential mortgage lenders in the UK on the basis of outstanding balances, with mortgage balances outstanding at 31 December 2008 of £112,894 million.

UK Wealth Management. Wealth Management provides financial planning and advice for the Group s affluent customers, providing financial solutions across investments, retirement planning and income, trusts, tax and estate planning as well as share dealing. Expert advice is provided through a large number of financial advisors who can be accessed via the retail branch network and Private Banking offices throughout the United Kingdom. Customers are also provided with access to relationship banking through Lloyds TSB Wealth Management, one of the largest providers of private banking services in the UK, based on assets under management.

INSURANCE AND INVESTMENTS

During 2008, Insurance and Investments offered life assurance, pensions and investment products, general insurance and fund management services.

Life assurance, pensions and investments. In 2008, Scottish Widows was the Group s specialist provider of life assurance, pensions and investment products, which are distributed through Lloyds TSB Bank s branch network, through independent financial advisors and directly via the telephone and the internet. The Scottish Widows brand was the main brand for new sales of the Group s life, pensions, Open Ended Investment Companies (OEICs) and other long-term savings products.

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 fund is divided into With Profit and Non-Profit sub-funds.

With-profits life and pensions products are written from the With Profit sub-fund. 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 the Non-Profit sub-fund. 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.

During 2007, the Group sold Abbey Life, the UK life operation which was closed to new business in 2000.

General insurance. Lloyds TSB General Insurance provides general insurance through retail branches of Lloyds TSB Bank and C&G, a direct telephone operation, the internet and through third party panel or other distribution channels. Lloyds TSB General Insurance is one of the leading distributors of home insurance in the UK.

Scottish Widows Investment Partnership. Scottish Widows Investment Partnership manages funds for the Group s retail life, pensions and investment products. Clients also include corporate pension schemes, local authorities and other institutions in the UK and overseas.

BUSINESS

WHOLESALE AND INTERNATIONAL BANKING

In 2008, Wholesale and International Banking provided banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provided asset finance to personal and corporate customers, managed the Group s activities in financial markets through its treasury function and provided banking and financial services overseas.

Corporate Markets. Combining the respective strengths of some 3,000 employees in Corporate Banking and Products and Markets, Corporate Markets plays an integral role in leveraging and expanding the customer franchise and building deep, long-lasting relationships with around 26,000 corporate customers at 31 December 2008.

Corporate Banking manages the Group s core corporate customer franchise, providing a relationship-based financial and advisory service to the corporate market place through dedicated regional teams throughout the UK and key strategic locations abroad, including New York. Customers have access to expert advice and a broad range of financial solutions. Relationship managers act as a conduit to product and service partners in Corporate Markets and other parts of the Group.

Products and Markets is where the specialist product capability resides for transactions undertaken by the corporate customers of the Group. It offers customers a comprehensive range of finance and capital solutions, and also provides tailored risk management solutions and structured solutions across all areas of risk, including foreign exchange, interest rates, credit, inflation and commodities on behalf of the Group. Additionally, Products and Markets fulfils the treasury role for the Group, managing balance sheet liquidity.

Commercial Banking. At 31 December 2008, Commercial Banking served nearly one million customers across the UK from one-person start-ups to large, established enterprises. The business focuses on providing banking facilities and solutions to customers with business turnover up to £15 million per annum, and additionally provides specialised working capital finance for its customers through its Commercial Finance subsidiary, and long-term finance to the agricultural sector through the Agricultural Mortgage Corporation. In 2008, Commercial Banking increased its lending to small to medium sized entities (SMEs) by nearly 20 per cent.

Asset Finance. The Group s asset finance businesses provide individuals and companies with specialist personal lending, store credit and finance through leasing, hire purchase and contract hire packages. Hire purchase is a form of consumer financing where a customer takes possession of goods on payment of an initial deposit but the legal title to the goods does not pass to the customer until the agreed number of instalments have been paid and the option to purchase has been exercised. Altogether, at 31 December 2008, Asset Finance had over 1.5 million individual customers and relationships with some 22,000 companies and small businesses.

International Banking. The Group has continued to shape its international network to support its UK operations. Its overseas banking operations include offices in the UK, the Channel Islands, the Isle of Man, Dubai, Hong Kong, Spain, France, Switzerland, Luxembourg, Belgium, Netherlands, Monaco, Gibraltar, Cyprus, South Africa, Japan, Singapore, Malaysia, China and the US. The business provides a wide range of private and retail banking, wealth management and expatriate services to local residents, UK expatriates, foreign nationals and to other customers and also serves the corporate and institutional markets in a number of these locations.

LLOYDS BANKING GROUP SEGMENTS IN 2009

Following the acquisition of HBOS plc on 16 January 2009, the Group created a new division, Wealth and International. The new Group s activities are to be organised into four divisions: Retail, Insurance, Wealth and International, and Wholesale.

MATERIAL CONTRACTS

Lloyds Banking Group plc and its subsidiaries are party to various contracts in the ordinary course of business.

In 2008, the Company entered into a placing and open offer agreement with HM Treasury and the joint sponsors and joint bookrunners named therein, as well as a preference share subscription agreement with HM Treasury, both with effect from 13 October 2008. In addition, the Company entered into a registration rights agreement with HM Treasury on 12 January 2009 pursuant to an obligation to do so under the 13 October 2008 placing and open offer agreement. Prior to the completion of the acquisition of HBOS, HBOS also entered into a placing and open offer agreement with HM Treasury and the joint sponsors and joint bookrunners named therein, as well as a preference share subscription agreement with HM Treasury, both with effect from 13 October 2008. For further details on each of the 2008 agreements described above, see Major Shareholders and Related Party Transactions Information about the Lloyds Banking Group s Relationship with the UK Government .

In 2009, in addition to the registration rights agreement discussed above, the Company entered into the following agreements, which it considers to be material:

2009 PLACING AND OPEN OFFER AGREEMENT

Pursuant to the 2009 Placing and Open Offer Agreement dated 7 March 2009 (as amended and restated on 20 March 2009) entered into between the Company, HM Treasury and the joint sponsors and joint bookrunners named therein, (i) the Company agreed to invite qualifying shareholders (which, subject to certain limited exceptions, does not include US shareholders or ADS holders, to whom no offer is being made) to apply to subscribe for 10,408,535,000 ordinary shares at an issue price of 38.43 pence per share by way of an open offer, (ii) the joint sponsors and joint bookrunners were appointed and agreed to use reasonable endeavours to procure placees to subscribe for the open offer shares on such terms as may be agreed by the Company and HM Treasury at not less than the issue price on the basis that the open offer shares placed will be subject to clawback to the extent they are taken up under the open offer and (iii) HM Treasury agreed that, to the extent not placed or taken up under the open offer and subject to the terms and conditions set out in the 2009 Placing and Open Offer Agreement, HM Treasury will subscribe for such open offer shares itself at the issue price.

The aggregate proceeds of the placing and open offer (net of expenses) will be used to fund the redemption, on admission to the Official List and to trading on the London Stock Exchange s main market (Admission), of the preference shares held by HM Treasury (the Preference Shares) at 101 per cent of their issue price (£4,040,000,000) together with the accrued dividend on the Preference Shares (from and including 15 January 2009 to but excluding the date of Admission) and the commissions payable to HM Treasury under the 2009 Placing and Open Offer Agreement. Since the proceeds of the placing and open offer would be insufficient to fund the redemption of the Preference Shares, the Company shall provide additional financing from its own resources and make use of its own reserves to enable such redemption to be effected in full.

BUSINESS

In consideration of the provision of its services under the 2009 Placing and Open Offer Agreement, the Company shall pay to HM Treasury (i) a commission of 0.5 per cent of the aggregate value of the open offer shares at the issue price per open offer share payable on the earlier of Admission and the second business day after the day on which the 2009 Placing and Open Offer Agreement is terminated and (ii) a further commission of 1 per cent of the aggregate value of the open offer shares subscribed for by placees or by HM Treasury at the issue price per open offer share payable on the date of Admission.

The Company shall pay to each of HM Treasury, the joint sponsors and joint bookrunners all legal and other costs and expenses (properly incurred in the case of the joint sponsors and joint bookrunners) and those of HM Treasury s financial advisers, incurred in connection with the placing and open offer, the redemption of the Preference Shares or any arrangements referred to in the 2009 Placing and Open Offer Agreement.

The Company shall also bear all costs and expenses relating to the placing and open offer and the Preference Share redemption, including (but not limited to) the fees and expenses of its professional advisers, the cost of preparation, advertising, printing and distribution of all documents connected with the placing and open offer and the Preference Share redemption, the listing fees of the FSA, any charges by CREST and the fees of the London Stock Exchange and Euronext.

The obligations of HM Treasury, the joint sponsors and joint bookrunners under the 2009 Placing and Open Offer Agreement are subject to conditions including, amongst others:

(i) the passing of certain resolutions to be proposed at a general meeting;

(ii) the passing of all necessary resolutions to approve the participation by the Group in the GAPS and to create and authorise the issue of the Class B Shares in connection therewith;

(iii) in the opinion of HM Treasury (acting in good faith) no event having occurred or being reasonably likely to occur which has resulted in or may result in a material adverse change in or affecting the condition (financial, operational, legal or otherwise), profitability, prospects, solvency, business affairs or operations of the Group, taken as a whole, whether or not arising in the ordinary course of business;

(iv) the obtaining of regulatory approvals; and

(v) Admission becoming effective by not later than 8.00 a.m. on 7 July 2009 (or such later time and date as HM Treasury may agree).

Certain of the conditions may be waived by HM Treasury at its discretion. Prior to Admission, HM Treasury, the joint sponsors and joint bookrunners may terminate their respective obligations under the agreement in certain circumstances.

HM Treasury may terminate the 2009 Placing and Open Offer Agreement in certain specified circumstances, but only where HM Treasury does not consider it to be necessary that the arrangements contemplated by the 2009 Placing and Open Offer Agreement proceed to completion in order to maintain the financial stability of the United Kingdom. On termination of appointment by the joint sponsors and joint bookrunners the agreement will continue to be in force as between the non-terminating parties.

The Company has given certain representations and warranties and indemnities to each of HM Treasury, the joint sponsors and joint bookrunners under the 2009 Placing and Open Offer Agreement. The Company s liabilities thereunder are unlimited as to time and amount.

HM Treasury is entitled to novate its rights under the agreement to any entity that is wholly-owned, directly or indirectly, by HM Treasury.

The Company has undertaken to amend the Registration Rights Agreement entered into on 12 January 2009 to include as Registrable Securities (as defined in the Registration Rights Agreement) any new shares subscribed for under the 2009 Placing and Open Offer Agreement, any Class B Shares and other securities in the Company held by HM Treasury from time to time and securities issued by HM Treasury from time to time and which are exchangeable for, convertible into, give rights over or are referable to such new shares or other securities. The Company has also undertaken to enter into a resale rights agreement, in order to enable certain securities of the Company held by HM Treasury and securities issued by HM Treasury which are exchangeable for, convertible into, give rights over or are referable to such securities to be sold in such jurisdictions and in such manner as HM Treasury determines.

LENDING COMMITMENTS DEED

On 6 March 2009, the Company entered into a deed poll in favour of certain UK Government departments under which it undertook to support lending to creditworthy borrowers in the UK in a commercial manner with effect from 1 March 2009. This lending commitment is a pre-requisite to the Group s proposed participation in the GAPS, the objective of which is to reinforce the stability of the UK financial system and support the recovery of the UK economy.

A condition to the participation in the GAPS is the commitment by the Company to increase lending by approximately £14,000 million in the twelve months commencing 1 March 2009 to support UK businesses (approximately £11,000 million) and homeowners (approximately £3,000 million), and to maintain in the twelve months commencing 1 March 2010 similar levels of lending as in the twelve months commencing 1 March 2009, subject to adjustment of the lending commitments by agreement with HM Treasury and the Department for Business, Enterprise and Regulatory Reform to reflect circumstances at the start of the twelve month period commencing 1 March 2010. This additional lending in 2009 and 2010 will be subject to the Group s prevailing commercial terms and conditions (including pricing and risk assessment) and, in relation to mortgage lending, the Group s standard credit and other acceptance criteria.

The Group s compliance with its lending commitment will be subject to a reporting process.

The Company has also made certain undertakings as regards marketing in support of its lending commitments and certain other matters relating to its business and residential lending practices and policies. The lending commitments made in the deed poll supersede the commitments given by the Company in October 2008 in connection with the UK Government s recapitalisation scheme.

These lending commitments will be adjusted by the UK Government, in consultation with the Group, if the GAPS is not implemented within the timeframes anticipated for such implementation and the Group only participates in the UK Government s credit guarantee scheme.

The Company has also undertaken to increase its lending to support creditworthy borrowers in the real economy if any of the preference shares held by HM Treasury are exchanged for ordinary shares in the Company. The quantum of such increased lending shall be determined by reference to the increased lending capacity of the Group after taking into account the long-term effects of the exchange of the preference shares held by HM Treasury.

BUSINESS

PRE-ACCESSION DEED

On 7 March 2009, the Company entered into a deed poll in favour of HM Treasury, pursuant to which the Company gave a series of undertakings, with effect from the date of the deed poll unless otherwise agreed, in relation to the provision of information and the management of the proposed assets, commitments and exposures proposed to be included in the GAPS (the Proposed Assets) in the period to the Group s proposed accession to the GAPS.

The Company has undertaken to HM Treasury, among other things, to:

(i) provide all such assistance and information and data as is reasonably requested which is pertinent to the implementation of the GAPS and the Group s potential participation in the GAPS;

(ii) provide, as soon as practicable, an indicative list of the Proposed Assets with a view to agreeing such list by 30 April 2009;

(iii) provide, as promptly as practicable, information and data relating to the Proposed Assets reasonably requested for due diligence purposes and to provide certain other information concerning the Group s business and the financial performance and risk of the Proposed Assets;

(iv) provide access to the Group s premises, books, records, senior executives, relevant personnel and professional advisers on reasonable terms;

(v) consult with HM Treasury regarding the management and operations of the Proposed Assets and to ensure that the management of the Proposed Assets is in accordance with usual business practices and also without regard to the possible benefits under the GAPS; and

(vi) use best endeavours (giving regard to reasonable operational requirements) to maintain regular, adequate and effective monitoring, reporting, risk management and audit controls and procedures in order, among other things, to ensure that risks relating to key business processes which affect the Proposed Assets are identified, assessed and reported and are managed and mitigated appropriately.

The Company has acknowledged that it has agreed with the UK Government certain commitments regarding remuneration for the years 2008 and 2009. The Company has further acknowledged that HM Treasury and the FSA propose to commence a consultation in relation to a Code of Remuneration Practice for banking institutions and has confirmed that it will develop a remuneration policy which complies with any such Code by no later than three months from the date of the deed poll.

The Company has agreed to enter into a resale rights agreement with HM Treasury, prior to the date on which any member of the Group accedes to the GAPS, in order to enable securities of the Company held by HM Treasury and securities issued by HM Treasury which are exchangeable for, convertible into, give rights over or are referable to such securities to be sold in such jurisdictions and in such manner as HM Treasury determines.

PROPERTIES

As at 31 December 2008, Lloyds Banking Group occupied 3,422 properties in the UK. Of these, 481 were held as freeholds, 53 as long-term leaseholds and 2,888 as short-term leaseholds. The majority of these properties are retail branches and ATM sites, widely distributed throughout England, Scotland and Wales. Other buildings include the Lloyds Banking Group s head office in the City of London, and customer service and support properties located as at 31 December 2008 to suit business needs, but clustered largely in London, Birmingham and Bristol (in England), Edinburgh (in Scotland) and Cardiff and Newport (in Wales).

In addition, Lloyds Banking Group, as at 31 December 2008, owned, leased or used under licence properties for business operations elsewhere in the world, principally in Spain, Switzerland, Dubai and Asia.

On 16 January 2009, the Company acquired HBOS and, as a result, the Group occupied significantly more properties from this date.

LEGAL ACTIONS

Lloyds Banking Group is periodically subject to threatened or filed legal actions in the ordinary course of business. Further information, as at 31 December 2008, is included in Legal proceedings in note 48 on page F-69.

In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney s Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices. The Group disclosed in its interim results for the first half of 2008 that it was in discussions regarding a resolution of the investigation and that it had provided £180 million in respect of this matter. The provision was hedged into US dollars at the time and fully covers the settlement amount announced in January 2009. The Group is continuing discussions with the Office of Foreign Assets Control (OFAC) regarding the terms of the resolution of its investigation. OFAC has confirmed to the Group that the amount paid to the US Department of Justice and the New York County District Attorney s Office will be credited towards satisfying any penalty it imposes. The Group does not currently believe that any additional liability requiring provision will arise following the conclusion of the discussions with OFAC. The Group does not anticipate any further enforcement actions as to these issues. A purported shareholder filed a derivative civil action in the Supreme Court of New York, Nassau County on 26 February 2009 against certain current and former directors, and nominally against Lloyds TSB Bank plc and Lloyds Banking Group plc, seeking various forms of relief following the settlement. The derivative action is at a very early stage.

The Group is also engaged in High Court legal proceedings issued by the UK Office of Fair Trading, proceedings before the European Court of First Instance in relation to interchange fees and proceedings before the UK Competition Appeal Tribunal in relation to the UK Competition Commission s findings in relation to payment protection insurance (see Regulation UK Office of Fair Trading and Regulation UK Competition Commission).

COMPETITIVE ENVIRONMENT

Lloyds Banking Group is a diversified UK-based financial services group providing a wide range of banking and financial services, predominantly in the UK, to personal and corporate customers. Its main business activities 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.

BUSINESS

The Group s businesses are subject to inherent risks arising from general and sector-specific economic conditions in the markets in which it operates, particularly the United Kingdom in which the Group s earnings are predominantly generated. Following the completion of the acquisition of HBOS plc on 16 January 2009, the Group now operates in an increased number of other jurisdictions; these include Ireland, Australia and the United States, and hence the Group is exposed to general and sector-specific economic conditions in these markets as well. Over approximately the past 18 months, the global economy and the global financial system have been experiencing a period of significant turbulence and uncertainty, particularly the very severe dislocation of the financial markets around the world, that began in August 2007 and has substantially worsened since September 2008, and related problems at many large global and UK commercial banks, investment banks, insurance companies and other financial and related institutions.

RECENT DEVELOPMENTS

SHARE CAPITAL

On 19 November 2008, Lloyds Banking Group plc shareholders approved, subject to certain conditions, an increase in the Company s share capital by creating 14,911,908,221 new ordinary shares of 25 pence each, and creating 625,000,000 new preference shares of 25 pence each. These conditions were met in January 2009.

On 13 January 2009, the Company issued 2,596,653,203 ordinary shares at 173.3p, largely subscribed for by HM Treasury, raising a total of £4,500 million.

On 15 January 2009, the Company issued £1,000,000,000 12 per cent fixed to floating non-cumulative callable preference shares to HM Treasury pursuant to the preference share subscription agreement entered into with effect from 13 October 2008 by the Company and HM Treasury. These preference shares became fungible with the £3,000,000,000 12 per cent fixed to floating non-cumulative callable preference shares issued by the Company on 16 January 2009 (see below); under the terms of these preference shares, the payment of cash dividends to ordinary shareholders is not permitted until the preference shares are repaid.

Following the acquisition of HBOS (see below), on 16 January 2009 the Group cancelled a number of HBOS preference share issuances in exchange for preference shares issued by Lloyds Banking Group plc. In this regard, the Company issued £299,987,729 9.25 per cent fixed rate non-cumulative preference shares, £99,999,942 9.75 per cent fixed rate non-cumulative preference shares, £186,190,532 6.475 per cent fixed rate non-cumulative preference shares, £745,431,000 6.0884 per cent fixed to floating rate non-cumulative callable preference shares, £334,951,000 6.3673 per cent fixed to floating non-cumulative callable preference shares, US$750,000,000 6.413 per cent fixed to floating rate non-cumulative callable preference shares, US$750,000,000 5.92 per cent fixed to floating rate non-cumulative callable preference shares, US$750,000,000 6.657 per cent fixed to floating rate non-cumulative callable preference shares and £3,000,000,000 12 per cent fixed to floating non-cumulative callable preference shares.

On 19 January 2009, the Company issued US$1,250,000,000 7.875 per cent non-cumulative callable preference shares and 500,000,000 7.875 per cent non-cumulative callable preference shares.

ACQUISITION OF HBOS PLC

On 16 January 2009, the Company acquired 100 per cent of the ordinary share capital of HBOS plc, which together with its subsidiary and associated undertakings undertakes banking, insurance and other financial services related activities. Under the terms of the acquisition, HBOS shareholders received 0.605 Lloyds Banking Group plc shares for every 1 HBOS share.

The total fair value of the purchase consideration was £7,751 million, comprising 7,775,694,993 Lloyds Banking Group plc ordinary shares with a fair value of £7,651 million based on a closing price of 98.4p per ordinary share on 15 January 2009, the trading day immediately prior to completion, and directly attributable transaction costs of approximately £100 million.

Because of the limited time available since the acquisition, the Group is still in the process of establishing the fair value of the assets and liabilities acquired. The audited net assets of HBOS at 31 December 2008 were £13,499 million. See also Risk Factors Business and Economic Risks Market conditions have resulted, and are expected to result in the future, in material changes to the estimated fair values of financial assets of the Group.

Negative fair value adjustments have had, and may continue to have in the future, a further material adverse effect on the Group s operating results, financial conditions and prospects .

CAPITALISATION ISSUE

On 19 November 2008, the Company s shareholders approved, subject to certain conditions, a resolution authorising the board to capitalise an amount out of the Company s reserves and to apply such amount in paying up new Company shares. On 26 February 2009, the board approved a capitalisation issue of one for forty ordinary shares held.

NAME CHANGE

On 19 November 2008, the Company s shareholders approved, subject to certain conditions, a resolution changing the name of the Company to Lloyds Banking Group plc. These conditions were met and the Company changed its name on 16 January 2009.

UK GOVERNMENT ASSET PROTECTION SCHEME

Lloyds Banking Group plc announced on 7 March 2009 that it intends to participate in the UK Government s Asset Protection Scheme (GAPS), in order to reduce its risk-weighted assets and strengthen the Group s capital position. The Company has also agreed to replace the £4,000 million of preference shares held by HM Treasury with new ordinary shares which will be offered to existing shareholders on a pre-emptive basis. Participation in the GAPS and the replacement of the preference shares is subject to, among other things, shareholder approval. See Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government for more information regarding actions taken by HM Treasury in respect of the Group.

SCHEME AMOUNT

The Group intends to participate in the GAPS in respect of assets and exposures (Covered Assets) of the enlarged Group at 31 December 2008 with an aggregate par value of approximately £260,000 million (expected to be approximately £250,000 million net of December 2008 impairment allowances and write-downs). The Covered Assets are expected to include residential mortgages (approximately £74,000 million), unsecured personal loans (approximately £18,000 million), corporate and commercial loans (including commercial real estate and leveraged finance loans) (approximately £151,000 million) and treasury assets (including the Group s Alt-A portfolio) (approximately £17,000 million).

BUSINESS

It is expected that approximately 83 per cent of the Covered Assets will come from HBOS legacy lending books and the balance from Lloyds TSB Group legacy books.

FIRST LOSS

The Group will bear a first loss amount in respect of the Covered Assets. The amount of the first loss is expected to be up to £25,000 million (after taking into account historic impairments and write-downs), although this amount has not yet been finalised and could increase as the terms of the GAPS are negotiated and finalised.

After the first loss, the Group will retain an exposure of 10 per cent of any further losses incurred in respect of the Covered Assets. The remaining 90 per cent of further losses arising in respect of the Covered Assets will be borne by HM Treasury. The GAPS will apply to losses incurred in respect of assets and exposures on the balance sheet as at 31 December 2008, regardless of when such losses are incurred.

FEE AND RELATED ISSUANCE OF CAPITAL

Upon accession to the GAPS, the Company will pay a fee to HM Treasury of £15,600 million. This fee will be amortised over an estimated 7 year period. The proceeds of this fee will be applied by HM Treasury in subscribing for an issue by Lloyds Banking Group plc of B Shares, carrying a dividend of the greater of 7 per cent per annum and 125 per cent of the dividend on ordinary shares. The B Shares will constitute core tier 1 capital. The overall cost to the Group of participating in the GAPS, as a percentage of the reduction in risk-weighted assets, totals 20.9 per cent.

The B Shares, which are non-voting, are convertible at any time at the holder s option into ordinary shares in Lloyds Banking Group plc at a price of 115 pence per ordinary share, and are mandatorily convertible into ordinary shares at that price if the volume weighted average trading price of the ordinary shares for 20 trading days in any 30 trading day period equals or exceeds 150 pence.

The Company has not entered into any agreement to restrict the utilisation of any existing or future UK tax losses or allowances.

CAPITAL RESTRUCTURING REPLACEMENT OF EXISTING PREFERENCE SHARES

On 7 March 2009, the Company also agreed with HM Treasury that the £4,000 million of preference shares HM Treasury holds (together with accrued dividends) will be replaced with new ordinary shares of Lloyds Banking Group plc. Eligible Lloyds Banking Group plc ordinary shareholders will be able to apply to subscribe for approximately £4,000 million of new ordinary shares pro rata to their existing shareholdings at a fixed price of 38.43 pence per share. This represents an 8.5 per cent discount to the closing price on 6 March 2009. These new ordinary shares will be offered to eligible shareholders and new investors on a similar basis as the placing and open offer made in November 2008 (see Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government). The ordinary share offer is fully underwritten by HM Treasury on substantially the same fee basis as the placing and open offer conducted in November 2008. The proceeds of the issue, together with the Group s existing cash resources, will be used to redeem the £4,000 million of preference shares noted above.

The preference shares will be redeemed at 101 per cent of their issue price. Dividends will continue to accrue on the preference shares until redemption. The redemption of the preference shares held by HM Treasury will remove the annual cost of the preference share dividends of £480 million and will improve the Group s cash flow and capital position. In addition, upon redemption of the preference shares, the prohibition on payment of ordinary dividends currently in place will be removed. However, it is not the board s intention to pay a dividend on ordinary shares in 2009.

The new ordinary shares will not be registered under the Securities Act and may not be offered or sold in the United States absent registration or an applicable exemption from the registration requirements of the Securities Act.

IMPACT OF PREFERENCE SHARE REPLACEMENT AND B SHARE CONVERSION

If eligible shareholders do not take up any entitlement to the ordinary shares to be issued pursuant to the preference share replacement or if other new investors do not acquire them, HM Treasury will own approximately 65 per cent of the ordinary shares of Lloyds Banking Group plc. In addition, in the event of full conversion of the B Shares, if HM Treasury retained all the ordinary shares resulting from such conversion and assuming it still retained all its existing shareholding in Lloyds Banking Group plc, then HM Treasury s aggregate ordinary shareholding would be 77 per cent. HM Treasury may not exercise its option to convert the B

Shares to the extent that by doing so it would hold more than 75 per cent of the ordinary shares in Lloyds Banking Group plc, although this limitation does not apply in the event of mandatory B Share conversion. In no circumstances will HM Treasury be able to exercise more than 75 per cent of the voting rights in Lloyds Banking Group plc.

HM Treasury has confirmed to the board that its objective in increasing its potential holding of ordinary shares in the Group is to provide financial support. In the event that HM Treasury increases its ownership of the ordinary shares, it does not envisage any change to the constructive relationship it currently enjoys with the board.

LENDING

A condition to the participation in the GAPS is the committment by the Company to increase lending by approximately £14,000 million in the twelve months commencing 1 March 2009 to support UK businesses (approximately £11,000 million) and homeowners (approximately £3,000 million) and to maintain in the twelve months commencing 1 March 2010 similar levels of lending as in the twelve months commencing 1 March 2009, subject to adjustment of the lending commitments by agreement with HM Treasury and the Department for Business, Enterprise and Regulatory Reform to reflect circumstances at the start of the twelve month period commencing 1 March 2010. This additional lending in 2009 and 2010 will be subject to the Group s prevailing commercial terms and conditions (including pricing and risk assessment) and, in relation to mortgage lending, the Group s standard credit and other acceptance criteria.

This lending commitment is part of the Group s ongoing support for UK businesses and homeowners. The Group has pledged its support for various UK Government schemes designed to provide additional funding for small businesses. The Group has also published charters for its small business customers making a range of pledges to help firms through the economic downturn, including a pledge to reduce business interest rates in line with the UK base rate.

TERM

While it is intended that the GAPS will apply to the Covered Assets until their maturity, the Group s participation in the GAPS will be capable of termination by mutual agreement of the Group and HM Treasury.

ONGOING MANAGEMENT OF THE COVERED ASSETS

On accession to the GAPS, Lloyds Banking Group will be required to manage the Covered Assets in accordance with the asset management requirements under the GAPS.

As the GAPS is intended to apply to losses arising before the GAPS comes into operation, the Group has agreed with HM Treasury certain interim arrangements relating to the management of those assets and exposures likely to be part of the GAPS.

BUSINESS

CONDITIONS TO ACCESSION TO GAPS

Participation in the GAPS will depend on the satisfaction of a number of conditions which may not be satisfied, including, among others, the completion of due diligence by (and to the satisfaction of) HM Treasury, the receipt of certain regulatory approvals (including European state aid clearance), the approval of the Company s board and a majority of the Company s independent shareholders (that is, shareholders excluding HM Treasury), finalisation of the terms of the GAPS and Lloyds Banking Group s participation therein and the satisfaction by Lloyds Banking Group of the application criteria and asset criteria (see Risk Factors Government-related Risks If Lloyds Banking Group is unable to participate in the GAPS, or the operation of the GAPS fails to have the desired effect on Lloyds Banking Group s financial and capital position, or the costs of participation outweigh the benefits, this could have a material adverse effect on the Group s results of operations, financial condition and prospects and Risk Factors Government-related Risks The aid given by and proposed to be given by HM Treasury to the Group is subject to European state aid review. The outcome of this review is uncertain at this stage and may involve the prohibition of some elements of the aid, the requirement for the Group to repay the aid or the imposition of conditions on the Group that may be significantly adverse to its interests).

BOARD CHANGE

On 17 March 2009, the Group announced that Jan du Plessis was to become chairman of Rio Tinto plc. He left the Lloyds Banking Group board on 17 April 2009 and was succeeded by Martin Scicluna as chairman of the audit committee.

INTERIM MANAGEMENT STATEMENT

Lloyds Banking Group issued an Interim Management Statement on 7 May 2009, which included the following comments:

KEY HIGHLIGHTS

(Unless otherwise stated, 2009 performance comparisons relate to the equivalent period in 2008 for the enlarged Group□s aggregated continuing businesses).

- The Group has delivered a good revenue performance in the first quarter of 2009 in what remains a difficult period for financial services companies.
- The Group□s net interest margin has reduced as a result of lower deposit margins and higher funding costs offsetting higher asset pricing.
- A strong cost performance has continued to be delivered, resulting in the Group□s costs in the first quarter of 2009 being marginally lower than in the first quarter of 2008.
- Corporate impairment levels are rising significantly, reflecting the continuing deterioration in the macro-economic environment. The vast majority of these higher corporate impairments relate to assets designated for inclusion in the Government Asset Protection Scheme. Write-downs of investment securities have reduced considerably.
- Excellent progress has been made on the integration of the enlarged Group.
- The Group□s intended participation in the Government Asset Protection Scheme will substantially reduce the risk profile of the organisation and significantly strengthen the capital position of the Group.
- As announced in February 2009, we continue to expect the Group to report a loss before tax for 2009, excluding the impact of a credit relating to negative goodwill.

Eric Daniels, Group Chief Executive, commented:

□In extremely challenging market and economic conditions, the Group has made good progress in its first few months. We have delivered a smooth transition to the newly enlarged Lloyds Banking Group and have a clear focus on developing the Group□s core businesses. Over the last few months we have designed and are implementing our new organisational structure, and we have already started to capture significant cost synergies. New management is in place and we have achieved all of our integration goals for the first 100 days of the enlarged Group.

Our intended participation in the Government Asset Protection Scheme, which we announced in March, will substantially reduce the risk profile of the Group□s balance sheet and significantly strengthen our capital position.

Whilst we continue to expect difficult economic conditions to prevail over the next year or so, we believe the strengthened Group will be able to comfortably manage through the expected near-term economic downturn and focus on enhancing the Group□s prospects for long-term growth.□

GOOD REVENUE GROWTH IN THE FIRST QUARTER OF 2009

The Group has delivered good revenue growth in the first quarter of 2009 with a good performance in Wholesale, as a result of lower investment write-downs, a more favourable interest and currency rate environment, good transaction volumes in capital markets and strong flows of client driven derivative transactions at improved spreads. The overall Group margin has benefited from higher asset margins but these have been more than offset by the impact of lower deposit margins, reflecting the impact of falling base rates, and higher funding costs as the Group continues to extend its wholesale funding maturity profile. We expect these trends in the Group net interest margin to continue throughout the rest of the year.

In Retail, we have continued to build our current account customer franchise, with some 500,000 new current accounts opened during the first quarter of the year. Whilst lending markets have remained subdued throughout the industry, the Group has continued to increase its estimated market share of net new mortgage lending in the first quarter of the year. Unsecured lending balances have remained broadly flat, again reflecting subdued customer demand. Lower levels of payment protection insurance income, reflecting the impact of last December□s announcement to move to a monthly premium product, and the impact of falling interest rates on deposit margins have led to retail banking revenues being slightly lower than in the first quarter of last year.

New business sales in our life assurance and pensions businesses were 22 per cent lower than in the first quarter of 2008, reflecting extremely challenging market conditions which have led to a general market-wide slowdown in the sale of life, pensions and investment products.

STRONG GROUP COST PERFORMANCE

The Group has an excellent track record in managing its cost base, and has continued to deliver a strong cost performance in the first quarter of 2009, resulting in the Groups costs being marginally lower than last year. We are already making significant progress in capturing savings from areas such as procurement and over £150 million of cost synergy run-rate savings have already been realised in the first quarter of the year. The Group is confident that it will meet its commitment to deliver cost synergies of greater than £1.5 billion per annum by the end of 2011.

RISING IMPAIRMENT LEVELS

Consistent with the guidance given in February this year, during the first quarter of 2009 we have experienced a significant rise in impairment levels in the Groups lending portfolios. This largely represents the impact of the further economic deterioration, including the effects of rising unemployment, reduced corporate cash flows, the continuing impact of lower house prices and falls in the value of commercial real estate.

As we have previously announced, we continue to expect retail impairment levels to rise significantly during 2009, in both the secured and unsecured lending portfolios. We expect continuing declines in commercial property prices and reducing levels of corporate cash flows as we anticipate a continuing difficult economic outlook. These factors are now leading us to anticipate further corporate defaults during the rest of the year, notably in the commercial real estate portfolios in the UK and Ireland. In particular, the real estate exposures in the legacy HBOS portfolios are more sensitive to a downturn in the economic environment. As a result, corporate impairments in 2009 are expected to be more than 50 per cent higher than in 2008.

In March, when the Group agreed to enter the Government Asset Protection Scheme, we included those portfolios that we expected would be most sensitive to a downturn in the economic environment. As a result, the vast majority of the corporate assets forecast to give rise to higher impairments are covered by the Groups intended participation in the Government Asset Protection Scheme. We continue to expect Treasury asset and investment portfolio write-downs to be significantly lower in 2009.

The initial fair value work undertaken on the HBOS lending portfolios acquired earlier in the year took into account an appropriate level of credit risk. Accordingly there will be a partially offsetting credit to the Groups 2009 income statement, reflecting an accelerated fair value adjustment unwind relating to this credit risk.

IMPROVING CAPITAL RATIOS AND STRONG LIQUIDITY AND FUNDING POSITION

Over the last few months, the Group has completed a number of balance sheet liability management transactions that have generated significant core tier 1 capital by redeeming certain securities at a discount to their balance sheet carrying value. A substantial number of note holders have accepted the various offers made and, as a result, the Group expects a pre-tax profit from these transactions of approximately £1 billion.

The Group has maintained a strong liquidity position and has continued to lengthen the maturity profile of the Groups wholesale liabilities. During the first quarter of 2009, the percentage of the Groups wholesale funding with a maturity of over one year continued to rise.

INTENDED PARTICIPATION IN THE GOVERNMENT ASSET PROTECTION SCHEME

As previously announced, the Groups participation remains subject to further due diligence by HM Treasury and agreement with regard to the detailed operation of the Scheme. Accordingly, discussions and negotiations with HM Treasury to finalise these matters are continuing and are expected to be concluded over the next few months.

The Groups implementation of the Government Asset Protection Scheme remains subject to obtaining regulatory and European Commission state aid clearance for the Government Asset Protection Scheme as a whole, as well as shareholder approval. An additional state aid approval will be needed from the European Commission for the Group's ongoing participation in the Government Asset Protection Scheme.

Other than the recent developments described in this section the Group is not aware of any significant change since the date of the consolidated financial statements.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The results discussed below are not necessarily indicative of Lloyds Banking Group s results in future periods. Unless expressly indicated, the results discussed in this section as well as the consolidated financial statements of Lloyds Banking Group included herein do not reflect the results of HBOS, which will be consolidated for the first time in 2009 and will therefore impact the comparability of 2009 and future periods with the results discussed below. 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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OVERVIEW AND TREND INFORMATION

THE ECONOMY AND THE GROUP S MARKETS

Coming into 2008, the UK economy had enjoyed 60 consecutive quarters of sustained expansion. Inflation remained very low during that time, helped by globalisation and the emergence of low cost economies as suppliers to the developed world.

Muted global inflation enabled central banks everywhere, including in the UK, to meet inflation objectives whilst maintaining interest rates at very low levels by historical standards. In this environment, UK real household incomes had grown strongly, as had corporate profits, and asset markets had boomed, notably housing. As in the US economy, low interest rates, low inflation, a booming housing market and high real income growth encouraged sustained high levels of consumer spending. Savings rates had fallen to very low levels and household debt had grown faster than income.

The Group had anticipated that this benign environment was unlikely to last, and had as a result positioned its business to avoid riskier parts of the lending market and to focus on the likely longer-term rebound of savings. However, it was unclear what the trigger might be for the change in the economic environment and the readjustment by consumers towards lower borrowing and higher savings.

The initial cause of the readjustment was a gradual rise in interest rates globally as the extremely rapid growth of the newly industrialising economies greatly increased demand for raw materials and sharply higher commodity prices caused inflation to surge. The current financial crisis started in August 2007, with growing evidence that weakness in US sub-prime lending due to higher interest rates was affecting the value of securitised assets held on the balance sheets of financial institutions globally. Although by the start of 2008 this had not affected the global economy materially, the outlook for the global, and UK, economy deteriorated significantly during 2008.

THE ECONOMY IN 2008

At the start of 2008, the consensus view was that the UK economy would grow by around 1.8 per cent on 2007 (source: Consensus Economics Inc). But as consumers spending power was squeezed by higher inflation and interest rates, and as consumer and business confidence collapsed, the consensus forecast gradually drifted downwards. The first full year figures for 2008 UK Gross Domestic Product (GDP) growth, released in late January 2009, showed a final annual growth figure of 0.7 per cent, with the second half showing negative growth. The last quarter of 2008 was particularly weak, due in large part to sharply lower manufacturing output, both in the UK and globally, as consumers cut spending on non-essentials, businesses cancelled investments and retailers reduced stocks. To date the slowdown owes more to lower business investment and weaker manufacturing and construction than it does to significant declines in consumer spending.

Graphical representations of the trends in the growth in UK GDP and UK consumer spending since 1985 are shown below.

UK GDP GROWTH

UK CONSUMER SPENDING GROWTH

By the end of 2008, house prices were down 16 per cent on a year earlier, using the Halifax House Price Index. While that decline improved affordability, with the ratio of house prices to average earnings having fallen from a peak of 5.8 in July 2007 to an estimated 4.4 by December 2008, the ratio remained above its long-term average of 4.0. UK household finances are starting to show signs of strain, however compared to the 1990s recession, they do not yet seem to be under the same pressure, perhaps because the preceding consumer boom had not been so strong but also because interest rates have fallen faster and further. The percentage of UK mortgagors reporting payment problems is around half the levels seen in the early 1990s. Although there has been some recent deterioration, other indicators of UK households financial distress, such as mortgage arrears and repossessions, are still at relatively low levels compared with the early 1990s. However, in late 2008 UK unemployment levels were rising at a faster rate than at a similar point during the early 1990s, with companies seemingly responding more quickly to worsening economic conditions.

The deterioration of economic prospects globally, combined with the initial impact of the financial crisis, has triggered a period of balance sheet adjustment by banks and other financial services companies, by non-bank companies and by individuals. Spreads in wholesale financial markets, on which many banks rely to fund their lending, widened sharply, with negative consequences for the availability and cost of credit for the broader economy. Balance sheet adjustment and high funding costs could, if left unchecked, make the global downturn even steeper and more damaging. Governments worldwide have responded by expansionary budget policy changes, by injecting capital into banks and by providing guarantees and other forms of support for wholesale funding markets.

Central banks have also responded, by sharply lowering the interest rates they control and by expanding their balance sheets to support financial markets. As a result, by early 2009, spreads in many financial markets had started to shrink, though remaining well above pre-crisis levels.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPACT ON THE GROUP S MARKETS

During the long upturn that preceded the current recession, consumer and corporate borrowing had grown at a strong pace, boosted by booming asset prices and seemingly low levels of risk. Savings growth had been modest by comparison. The current recession will see a significant change in that pattern, as households and businesses adjust to the new world. The first signs of that change are evident already.

Against the backdrop of a weakening economy, most major UK banking product markets slowed in 2008. With house prices falling throughout 2008, and with some banks withdrawing from mortgage lending, growth slowed. By late 2008, growth in mortgage balances outstanding was down to below 4 per cent, compared to 10 per cent in the previous year, and approvals for new mortgages were around 75 per cent below the level of 2007. However, those banks, like Lloyds TSB Bank, who were still active in the market, were continuing to experience stronger growth due to the withdrawal of other lenders. Unsecured personal lending growth also moderated, although balances outstanding on credit cards grew more strongly, suggesting that financial pressures on households were reducing the number paying off credit card outstandings in full each month.

The slowdown in both mortgages and unsecured lending is due to both demand and supply factors. A worsening economic outlook and falling house prices have depressed consumer confidence and curbed demand for both secured and unsecured borrowing. On the supply side, weak capital and funding positions have caused the withdrawal of some lenders from the market. Combined with increased perception of risk and falling asset values, this has restricted the aggregate supply of credit. However, the relative strength of the Group s capital and funding position, and its relationship-based approach, has enabled it to continue to grow its lending, thereby increasing its share of new lending.

In commercial and corporate banking markets, lending growth has also slowed. Again this is due to both supply and demand factors. The withdrawal of some banks from active participation in the market has reduced the aggregate supply of credit, and the increased cost of wholesale funding has raised the cost of finance. At the same time, cutbacks in investment in reaction to a worsening economic outlook have enabled many companies to cut their financing needs, although the reduced availability of trade credit plus tighter margins has weakened the cash flow of some. Weaker cash flow also helps to explain why corporate deposit growth turned negative in 2008. Shrinking corporate deposits, plus slowing household deposit growth has required those banks still growing their balance sheets to rely more heavily on wholesale funding.

THE OUTLOOK

The slowdown during the second half of 2008 means that the UK economy is now technically in recession (defined as a period of at least two consecutive quarters of negative growth). 2009 is likely to see that recession deepen. Views on 2009 economic prospects have also changed radically during 2008. At the start of 2008, the consensus forecast was that the UK economy would grow by 2 per cent in 2009. By early 2009, the consensus was for a fall of more than 2 per cent.

Against such an economic environment, the Group expects growth in its main markets to slow further during 2009, again driven by a mixture of demand and supply factors. Net mortgage lending may well turn negative in 2009 as house prices continue to fall. Unsecured lending will slow further as consumer spending on non-essentials is reduced. Savings growth will also be slow as pressures on household finances offset a desire to save more in an uncertain environment. Growth in commercial and corporate lending is expected to weaken as companies reduce investment spending further, and corporate deposit growth will remain weak. Given weak deposit growth by both households and firms, banks in aggregate will continue to rely on wholesale markets to fund net new lending. The likely continued high cost of wholesale funding, relative to base rates, will constrain banks ability to support the economy through credit growth.

Unemployment will continue to rise, although the extent of that rise is uncertain, depending for instance on how much companies have reacted more quickly on layoffs in this recession than they did in previous recessions. By the end of 2009 the housing market is expected to bottom out as affordability improves further. It is likely that further house price falls in 2009, combined with growth in average earnings, will reduce the ratio of house prices to average earnings to below the long-term average.

Against a backdrop of recession and an ongoing financial crisis, the Group expects 2009 to be another challenging year. Its overall performance in 2009 will be impacted significantly by the acquisition of HBOS which is likely to lead to increased revenues, costs and impairment charges. Revenues will also be affected by factors such as lower margins and the accounting impact of replacing its single premium payment protection insurance product with a new monthly premium product, as well as a general slowdown in the economy. The Group will continue to manage expenses tightly, but, in addition to the ongoing costs of the combined Group, will incur costs in order to realise synergies from the acquisition of HBOS. Excluding the acquisition of HBOS, the Group currently expects retail impairment levels to rise significantly in 2009, largely reflecting the expected increase in unemployment levels in the

UK and the impact of further house price falls. Corporate impairment levels are expected to remain at the high levels seen during 2008 and following the acquisition of HBOS are expected in 2009 to be significantly higher than those reported by Lloyds Banking Group in 2008. Overall, before the recognition of negative goodwill, the Group expects to report a loss before tax for 2009.

By 2010, the Group s scenarios all project the gradual restoration of growth, as growing confidence that the worst is over feeds through into a weak recovery in consumer spending and business investment, lower spreads in financial markets and a levelling off for asset prices. This is expected to be reflected in some strengthening of growth in the Group s main markets. There can be no assurance, however, that the Group s growth scenarios for 2010 will prove accurate.

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 51 to the consolidated financial statements.

RESULTS OF OPERATIONS 2008, 2007 AND 2006

SUMMARY

	2008 £m	2007 £m	2006 £m
Net interest income	**7,718**	6,099	5,329
Other income	**(705)**	12,129	14,344
Total income	**7,013**	18,228	19,673
Insurance claims	**2,859**	(7,522)	(8,569)
Total income, net of insurance claims	**9,872**	10,706	11,104
Operating expenses	**(6,053)**	(5,567)	(5,301)
Trading surplus	**3,819**	5,139	5,803
Impairment	**(3,012)**	(1,796)	(1,555)
Profit on sale and closure of businesses		657	
Profit before tax	**807**	4,000	4,248
Taxation	**38**	(679)	(1,341)
Profit for the year	**845**	3,321	2,907
Profit attributable to minority interests	**26**	32	104
Profit attributable to equity shareholders	**819**	3,289	2,803
Profit for the year	**845**	3,321	2,907
Economic profit[1]	**(172)**	2,238	1,855

1 The Group defines economic profit as the earnings on the equity invested in the business less a notional charge for the cost of the equity invested in that business. See Operating and financial review and prospects Economic profit .

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED WITH 2007

The Group s profit before tax in 2008 was £3,193 million, or 80 per cent, lower at £807 million compared to £4,000 million in 2007. Profit attributable to equity shareholders was £2,470 million, or 75 per cent, lower at £819 million compared to £3,289 million in 2007. Earnings per share were 44.0p, or 75 per cent, lower at 14.3p compared to 58.3p in 2007.

Net interest income increased by £1,619 million, or 27 per cent, to £7,718 million in 2008 from £6,099 million in 2007. Average interest-earning assets increased by £34,167 million, or 14 per cent, to £282,400 million in 2008 from £248,233 million in 2007, excluding the fine margin reverse repurchase agreement assets (instruments held for funding and liquidity purposes which are efficient in terms of regulatory capital requirements and on which, as a consequence, small interest margins are earned). The increase in average interest-earning assets consisted principally of an £8,652 million, or 9 per cent, rise in average retail mortgages and a £7,331 million, or 18 per cent, rise in corporate lending balances.

The net interest margin was 30 basis points higher at 2.63 per cent, or 27 basis points higher at 2.73 per cent excluding the fine margin reverse repurchase agreement assets. The increase in net interest margin largely reflects an improvement in margins on the unsecured lending products within UK Retail Banking, in Asset Finance and in Corporate Markets, partially offset by a deterioration in Commercial Banking margins as a result of an increase in the proportion of secured, lower margin lending; the margin within UK Retail Banking increased by 9 basis points and the margin within Wholesale and International Banking, excluding the fine margin reverse repurchase agreement balances, was 27 basis points higher.

Other income was a net expense of £705 million compared with net income of £12,129 million in 2007. The decrease of £12,834 million principally resulted from a decrease of £12,309 million in net trading income, with smaller decreases in net fee and commission income, of £87 million, other operating income, of £420 million, and insurance premium income, of £18 million. The reduction in net trading income principally arose in the Group s insurance businesses and arose from the losses on policyholder investments; this decrease was broadly matched by a reduction in the insurance claims expense and on other lines within the income statement. Net trading income in Corporate Markets was also adversely affected by the impact of the continued market turmoil in 2008. Fees and commissions receivable were £7 million higher at £3,231 million compared to £3,224 million in 2007; increases in fees from corporate banking and card services were largely offset by a reduction in fees from insurance broking and as a result of disposals in 2007. Fees and commissions payable were £94 million, or 16 per cent, higher at £694 million compared to £600 million in 2007 as a result of increases in fees payable related to added-value account packages and cards, in both cases as a result of increased business volumes. Other operating income was £420 million, or 44 per cent, lower at £532 million compared with £952 million in 2007. The majority of this reduction resulted from the deterioration of the value of in-force asset in the insurance business.

The insurance claims expense was a credit of £2,859 million in 2008 compared with an expense of £7,522 million in 2007. The negative returns in 2008 on policyholder investments in the long-term insurance business have led to a reduction in insurance related liabilities and a credit to the insurance claims expense. The charge in respect of general insurance was £109 million, or 36 per cent, lower at £193 million in 2008 compared to £302 million in 2007, principally reflecting the absence in 2008 of the severe weather related claims experienced in 2007.

Operating expenses were £486 million, or 9 per cent, higher at £6,053 million compared to £5,567 million in 2007. Operating expenses in 2008 included provisions in respect of certain historic US dollar payments and in respect of a Financial Services Compensation Scheme levy of £180 million and £122 million, respectively, and operating expenses in 2007 included £76 million in respect of the settlement of overdraft claims (see Operating expenses for more detail on these items). Staff costs were £27 million, or 1 per cent, higher at £2,931 million compared with £2,904 million in 2007. Salaries were £56 million higher at £2,183 million as the decrease in costs resulting from the sale of businesses in 2007 was more than offset by annual pay awards. Social security and pension and other post-retirement costs were broadly flat at £411 million in 2008 compared with £405 million in 2007. Other staff costs were £35 million, or 9 per cent, lower at £337 million in 2008; a further increase in agency staff costs (used to cover project work) has been more than offset by a decrease in redundancy costs as the level of particular restructuring initiatives seen in 2007 has not been repeated in 2008. Excluding the provisions in respect of certain historic US dollar payments and in respect of the Financial Services Compensation Scheme levy in 2008 and the settlement of overdraft claims in 2007, other administrative expenses increased £77 million, or 4 per cent, to £2,034 million in 2008 from £1,957 million in 2007.

The impairment charge in the income statement was £1,216 million, or 68 per cent, higher at £3,012 million in 2008 compared with £1,796 million in 2007. The 2008 charge comprised a charge of £2,876 million, compared to £1,721 million in 2007, in respect of impairment losses on loans and advances, a charge of £130 million, compared to £70 million in 2007, in respect of the impairment of available-for-sale financial assets and a charge of £6 million, compared to £5 million in 2007, relating to other credit risk provisions. In UK Retail Banking the charge increased by £248 million, or 20 per cent, to £1,472 million from £1,224 million in 2007;

for personal loans and overdrafts the charge increased by £100 million and the charge in respect of mortgages increased by £149 million. The impairment charge as a percentage of average lending was higher at 1.22 per cent compared to 1.10 per cent in 2007. In Wholesale and International Banking the charge in respect of impairment losses on loans and advances increased by £905 million, or 182 per cent, to £1,402 million from £497 million in 2007, reflecting the economic slowdown in the UK and the impact of a number of high profile financial services company collapses. Overall, the Group s charge in respect of impairment losses on loans and advances expressed as a percentage of average lending increased to 1.24 per cent compared to 0.84 per cent in 2007.

In 2007, a profit of £657 million arose on the sale of businesses, principally Abbey Life, a life assurance company, and Lloyds TSB Registrars, the company registration business of the Group.

In 2008, the Group recorded a tax credit of £38 million compared to a tax charge of £679 million in 2007. The tax credit arose as a result of the tax credits attributable to UK life insurance policyholders and the Group s interests in Open Ended Investment Companies (OEICs), which are required to be included within the income tax expense.

At the end of 2008, the total capital ratio was 11.2 per cent compared with 11.0 per cent at the end of 2007. Risk-weighted assets increased by £27,923 million, or 20 per cent; the increase in UK Retail Banking was £4,817 million, or 11 per cent, and in Wholesale and International Banking was £22,821 million, or 25 per cent. Total assets increased by £82,687 million, or 23 per cent, principally as a result of increases in loans and advances to customers, available-for-sale financial assets and derivatives.

The increase in loans and advances to customers and available-for-sale financial assets was in part caused by the strengthening of the US dollar against the pound sterling.

In accordance with the amendment to IAS 39, the Group reviewed the categorisation of its assets classified as held for trading and available-for-sale financial assets. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, the Group reclassified £2,993 million of assets classified as held for trading (measured at fair value through profit or loss immediately prior to reclassification) to loans and advances with effect from 1 July 2008 and £437 million of assets classified as available-for-sale financial assets (measured at fair value through equity) to loans and advances with effect from 1 November 2008. If the reclassifications had not been made, the Group s income statement for 2008 would have included unrealised fair value losses on the reclassified trading assets of £347 million and an additional impairment charge of £209 million in respect of available-for-sale financial assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2007 COMPARED WITH 2006

The Group s profit before tax in 2007 was £248 million, or 6 per cent, lower at £4,000 million compared to £4,248 million in 2006. Profit attributable to equity shareholders was £486 million, or 17 per cent, higher at £3,289 million compared to £2,803 million in 2006. Earnings per share were 8.4p, or 17 per cent, higher at 58.3p compared to 49.9p in 2006.

Net interest income was £770 million, or 14 per cent, higher at £6,099 million compared to £5,329 million in 2006, in part reflecting higher levels of policyholder related net interest income within the insurance businesses. Average interest-earning assets were £19,773 million higher, or £21,243 million higher excluding the fine margin reverse repurchase agreement assets; this reflects continued growth in mortgage lending and in corporate, treasury and structured finance balances. The net interest margin was 13 basis points higher at 2.33 per cent, or 11 basis points higher at 2.46 per cent excluding the fine margin reverse repurchase agreement assets. The increase in net interest margin largely reflects the higher level of policyholder related net interest income; the margin within UK Retail Banking fell by 12 basis points, as a result of the continuing change in mix towards finer margin mortgage balances, and the margin within Wholesale and International Banking, excluding the fine margin reverse repurchase agreement balances, was 2 basis points lower.

Other income was £2,215 million, or 15 per cent, lower at £12,129 million compared to £14,344 million in 2006. Fees and commissions receivable were £108 million, or 3 per cent, higher at £3,224 million compared to £3,116 million in 2006, mainly due to growth in UK current account fees and card fees. Fees and commissions payable were £38 million, or 6 per cent, lower at £600 million compared to £638 million in 2006, with the reduction arising in the insurance businesses. Net trading income was £3,218 million, or 51 per cent, lower at £3,123 million compared to £6,341 million in 2006, this movement is largely due to reductions in the gains on policyholder investments in the insurance businesses, which is broadly matched by reductions in the insurance claims expense and on other lines within the income statement, together with the impact of the market turmoil in the second half of 2007. Insurance premium income was £711 million, or 15 per cent, higher at £5,430 million compared to £4,719 million in 2006, reflecting growth in the life and pensions business, in part due to the success of a new corporate pensions product. Other operating income was £146 million, or 18 per cent, higher at £952 million compared to £806 million in 2006.

The insurance claims expense of £7,522 million was £1,047 million, or 12 per cent, lower than £8,569 million in 2006. The charge in respect of the life and pensions business was £1,149 million, or 14 per cent, lower at £7,220 million in 2007 compared to £8,369 million in 2006. The reduced returns in 2007 on policyholder investments in the long-term insurance business have led to a related reduction in amounts allocated to policyholders via the insurance claims expense. The impact of these lower allocations was partly offset by the releases from actuarial reserves in 2006 following FSA rule changes in that year. The charge in respect of general insurance was £102 million, or 51 per cent, higher at £302 million in 2007 compared to £200 million in 2006 as a result of increased weather related claims following severe flooding in the UK in June and July of 2007.

Operating expenses were £266 million, or 5 per cent, higher at £5,567 million compared to £5,301 million in 2006. However, if both the settlement of overdraft claims in 2007 and the pension credit in 2006 are excluded (see Operating expenses for more detail on both items), operating expenses were £62 million, or 1 per cent, higher at £5,491 million in 2007 compared to £5,429 million in 2006. Staff costs, excluding the £128 million pension schemes related credit from 2006, were £35 million, or 1 per cent, higher. Salaries were £10 million higher at £2,127 million as the decrease in costs resulting from the sale of businesses during 2007 and ongoing reductions in staff numbers was more than offset by annual pay awards and increased bonus and incentive costs. Excluding the one-off credit of £128 million from 2006, pension costs in 2007 were £55 million, or 19 per cent, lower than the underlying charge in 2006 following a reduction in the IAS 19 regular cost resulting from improved asset values at the end of 2006 and increased rates of return in 2007. Other staff costs were £74 million, or 25 per cent, higher at £372 million compared to £298 million in 2006 as a result of increased agency staff costs and general increases in other staff related expenditure. Premises and equipment costs were £20 million, or 3 per cent, lower at £619 million in 2007 compared to £639 million in 2006. Other costs, excluding the charge of £76 million in respect of the settlement of overdraft claims, were £36 million, or 3 per cent, higher at £1,338 million. Communications and external data processing costs were £37 million, or 7 per cent, lower at £462 million in 2007, compared to £499 million in 2006, as a result of efficiency initiatives; professional fees were £48 million, or 21 per cent, higher at £279 million compared to £231 million in 2006 due to significant expenditure on a number of projects and other costs were £17 million, or 4 per cent, higher at £405 million. Depreciation and amortisation was £11 million, or 2 per cent, higher at £630 million compared to £619 million in 2006.

The impairment charge in the income statement was £241 million, or 15 per cent, higher at £1,796 million in 2007 compared to £1,555 million in 2006; this comprised a charge of £1,721 million (2006: £1,560 million) in respect of impairment losses on loans and advances, a charge of £70 million (2006: £nil) in respect of the impairment of available-for-sale financial assets and a charge of £5 million (2006: a credit of £5 million) in respect of other credit risk provisions. In UK Retail Banking the charge reduced by £14 million, or 1 per cent, to £1,224 million from £1,238 million in 2006; for personal loans and overdrafts the charge reduced by £61 million following favourable collections experience and improved quality in new business, however the charge for the credit card portfolio increased by £37 million following a higher level of write-offs and lower recoveries. In Wholesale and International Banking the charge in respect of impairment losses on loans and advances increased by £184 million as a result of, in 2007, significant new charges for certain Corporate customers and a charge of £28 million in the leasing business resulting from the change in the UK corporation tax rate, and, in 2006, a greater level of releases and recoveries. Overall, the Group s charge in respect of impairment losses on loans and advances expressed as a percentage of average lending increased to 0.84 per cent compared to 0.83 per cent in 2006. In addition, a charge of £70 million in 2007 (2006: £nil) arose in respect of the impairment of available-for-sale financial assets.

In 2007, a profit of £657 million arose on the sale of businesses, principally Abbey Life, a life assurance company, and Lloyds TSB Registrars, the company registration business of Lloyds TSB Bank plc.

The tax charge, at £679 million, was £662 million lower than £1,341 million in 2006; this particularly reflects fluctuations in the level of tax attributable to UK life insurance policyholder earnings and the Group s interests in OEICs, which is required to be included within the income tax expense, the fact that no tax charge has arisen on the substantial profits on disposal of businesses in 2007 and the impact of the 2007 Finance Act reduction in the corporation tax rate which has led to a credit to the Group s tax charge in 2007 of £110 million.

At the end of 2007, the total capital ratio was 11.0 per cent. Risk-weighted assets (calculated according to Basel I requirements) increased by £15,928 million, or 10 per cent, from £156,043 million at 31 December 2006 to £171,971 million at the end of 2007, reflecting growth in mortgage balances and within the Corporate Markets business. Total assets increased by £9,748 million, or 3 per cent, to £353,346 million at 31 December 2007 from £343,598 million at the end of 2006 as growth in lending was, in part, offset by reductions in investment balances following the disposal of Abbey Life. Customer deposits increased by £17,213 million, or 12 per cent, to £156,555 million at the end of 2007 compared to £139,342 million at the end of 2006; this follows growth in current account credit balances and savings balances as well as in corporate deposits.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2008	2007	2006
Net interest income £m	**7,718**	6,099	5,329
Average interest-earning assets £m	**293,967**	262,144	242,371
Average rates:			
Gross yield on interest-earning assets[1] %	**5.98**	6.44	5.82
Interest spread[2] %	**2.37**	2.20	2.00
Net interest margin[3] %	**2.63**	2.33	2.20
Margin excluding average balances held under reverse repurchase agreements[4]:			
Net interest income £m	**7,718**	6,099	5,329
Average interest-earning assets £m	**282,400**	248,233	226,990
Net interest margin%	**2.73**	2.46	2.35

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

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

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

4 Comparisons of net interest income and margins are impacted by the holdings of fine margin reverse repurchase agreements. To improve comparability, figures are also shown excluding average balances held under reverse repurchase agreements (2008: £11,567 million; 2007: £13,911 million; 2006: £15,381 million).

2008 COMPARED TO 2007

Net interest income increased by £1,619 million, or 27 per cent, to £7,718 million in 2008 compared to £6,099 million in 2007. Within Insurance and Investments, net interest income was £235 million, or 65 per cent, higher as a result of a further decrease in the amounts payable to unitholders in those OEICs included in the consolidated results of the Group; since these are policyholder items there is no impact on profit attributable to shareholders. For the rest of the Group, net interest income increased by £1,384 million, or 24 per cent, to £7,120 million in 2008 compared to £5,736 million in 2007. This increase arose as a result of both asset growth and an improvement in margins.

Average interest-earning assets were £31,823 million, or 12 per cent, higher at £293,967 million in 2008 compared to £262,144 million in 2007. Excluding the fine margin reverse repurchase agreement assets held for liquidity purposes, average interest-earning assets were £34,167 million, or 14 per cent, higher at £282,400 million in 2008 compared to £248,233 million in 2007. Average interest-earning assets in UK Retail Banking were £9,234 million higher; average mortgage balances were £8,652 million higher, reflecting the Group s significantly increased share of net new mortgage lending, albeit in a reduced total market; and average balances on personal loans and overdrafts were £854 million higher although there was a small reduction in average credit card outstandings. Average interest-earning assets within the Insurance and Investments businesses, which include the mortgage book within Scottish Widows Bank, were £72 million lower; an increase of £722 million in the average mortgage balances was more than offset by a fall in deposit balances held by the consolidated funds. Within Wholesale and International Banking, average interest-earning assets increased by £22,547 million, or £24,891 million excluding the fine margin reverse repurchase agreement balances. Average balances within Corporate Markets, excluding the reverse repurchase agreement balances, were £19,333 million higher as the business improved levels of customer retention and continuing new business opportunities resulted in further growth in corporate lending and there was further balance growth in the lower margin treasury and structured finance areas. Further expansion of the Group s lending to smaller businesses led to a £2,819 million increase in average balances in Commercial Banking, and International Banking average balances were £2,907 million higher (in part reflecting exchange rate movements) although average balances within Asset Finance fell slightly.

The Group s net interest margin increased by 30 basis points to 2.63 per cent in 2008, compared to 2.33 per cent in 2007; if the average balances held under reverse repurchase agreements are excluded from both years, the margin in 2008 was 27 basis points higher at 2.73 per cent compared to 2.46 per cent in 2007. Within Insurance and Investments, the net interest income consolidated in respect of policyholder items was £190 million higher in 2008, as a result of the £229 million reduction in the amounts payable to unitholders in those OEICs included in the Group s results; this increase contributed some 7 basis points to the increase in the Group s net interest margin, excluding average balances held under reverse repurchase agreements. The net interest margin in UK Retail Banking was 9 basis points higher than in 2007, reflecting improved key product margins, particularly in unsecured personal lending and new mortgages. The margin within Wholesale and International Banking, excluding the fine margin reverse repurchase agreement balances, was 27 basis points higher. Margins continued to fall in Commercial Banking, as a result of a further change in mix towards secured, but lower margin, lending but there were improved margins in Asset Finance and within Corporate Markets. The improvement in margins in Corporate Markets reflected improvements in pricing of new lending and the benefit of favourable funding opportunities.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2007 COMPARED TO 2006

Net interest income increased by £770 million, or 14 per cent, to £6,099 million in 2007 compared to £5,329 million in 2006. Within the Insurance and Investments businesses, net interest income was higher as a result of a decrease in the amounts payable to unitholders in those OEICs included in the consolidated results of the Group. For the rest of the Group, net interest income increased by £321 million, or 6 per cent, to £5,736 million in 2007 compared to £5,415 million in 2006. This increase arose principally as a result of asset growth, partially offset by lower margins as a result of tighter underwriting criteria, competitive pressures and an increase in funding costs.

Average interest-earning assets were £19,773 million, or 8 per cent, higher at £262,144 million in 2007 compared to £242,371 million in 2006. Excluding the fine margin reverse repurchase agreement assets held for liquidity purposes, average interest-earning assets were £21,243 million, or 9 per cent, higher at £248,233 million in 2007 compared to £226,990 million in 2006. Average interest-earning assets in UK Retail Banking were £5,959 million higher; average mortgage balances were £6,462 million higher, reflecting the benefit of continued net new lending over 2006 and 2007, but average balances in other personal lending have fallen as a result of the contraction in credit card outstandings. Average interest-earning assets within the Insurance and Investments businesses, which include the mortgage book within Scottish Widows Bank, were £697 million higher. Within Wholesale and International Banking, average interest-earning assets increased by £13,132 million, or £14,602 million excluding the fine margin reverse repurchase agreement balances. Average balances within Corporate Markets, excluding the reverse repurchase agreement balances, were £11,698 million higher as a result of continued growth in corporate lending and in the lower margin balances within the treasury and structured finance areas. Continued growth in lending also led to a £2,343 million increase in average balances in Commercial Banking, although average balances within Asset Finance fell slightly.

The Group s net interest margin increased by 13 basis points to 2.33 per cent in 2007, compared to 2.20 per cent in 2006; if the average balances held under reverse repurchase agreements are excluded from both years, the margin in 2007 was 11 basis points higher at 2.46 per cent compared to 2.35 per cent in 2006. Within Insurance and Investments, the net interest income consolidated in respect of policyholder items was £383 million higher in 2007, in part due to a £229 million reduction in the amounts payable to unitholders in those OEICs included in the Group s results; this increase contributed some 15 basis points to the increase in the Group s net interest margin. The net interest margin in UK Retail Banking was 12 basis points lower as a result the adverse mix effect of growth in finer margin mortgages whilst the wider margin unsecured personal lending has been largely flat; product margins on a year-on-year basis fell slightly reflecting competitive pressures in the mortgage business which more than offset an increase in retail savings margins. The margin within Wholesale and International Banking, excluding the fine margin reverse repurchase agreement balances, was 2 basis points lower. Margins fell within Commercial Banking, as a result of growth being experienced in the more competitive, lower margin lending products, and in Asset Finance, as tightened underwriting criteria have led to better quality but lower margin lending, although margins within Corporate Markets improved, in part as a result of changes in funding arrangements.

OTHER INCOME

	2008 £m	2007 £m	2006 £m
Fee and commission income:			
UK current account fees	**707**	693	652
Other UK fees and commissions	**1,241**	1,215	1,210
Insurance broking	**549**	648	629
Card services	**581**	536	493
International fees and commissions	**153**	132	132
	3,231	3,224	3,116
Fee and commission expense	**(694)**	(600)	(638)
Net fee and commission income	**2,537**	2,624	2,478
Net trading income	**(9,186)**	3,123	6,341
Insurance premium income	**5,412**	5,430	4,719
Other operating income	**532**	952	806

Total other income	**(705)**	12,129	14,344

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED TO 2007

Other income was £12,834 million lower at a net loss of £705 million in 2008 compared to income of £12,129 million in 2007.

Fee and commission income was £7 million higher at £3,231 million in 2008 compared to £3,224 million in 2007. UK current account fees were £14 million higher reflecting growth in the numbers of higher-fee earning accounts during 2008. Insurance broking income was £99 million lower, driven by a sharp decrease in creditor insurance income as a side-effect of the reduced availability of consumer credit. Card fees were £45 million higher; merchant service charges were higher due to continuing growth in the merchant base and interchange income was £25 million higher as a result of increased levels of card usage. Other UK fees and commissions were £26 million higher at £1,241 million; continuing increases in factoring fees, corporate banking fees and asset management fees (in part due to the contracts entered into for the ongoing management of Abbey Life funds subsequent to disposal of that business in 2007) have offset the reductions in fees following the sale of Lloyds TSB Registrars and other businesses in 2007. International fees and commissions were £21 million higher at £153 million; there have been increased levels of business in the overseas corporate banking units.

Fee and commission expense was £94 million, or 16 per cent, higher at £694 million compared to £600 million in 2007. There have been increases in fees payable related to added-value account packages, in line with growth in the product, and higher levels of card fees payable as a result of the increased business volumes during 2008. There have also been increased levels of fees payable in respect of the Group s fund management activities and within its treasury operations.

Net trading income was £12,309 million lower at a loss of £9,186 million compared to income of £3,123 million in 2007. Of this decrease £10,917 million arose in the insurance businesses and represents reductions in the value of policyholder investments that are required to be reported gross in the income statement; the period-on-period decrease is largely matched by a compensating movement within the insurance claims figure which has moved by £10,381 million from a charge of £7,522 million in 2007 to a credit of £2,859 million in 2008. The remainder of the decrease, £1,392 million, arose within the banking businesses. Like many other financial institutions, the Group s Corporate Markets business has been significantly affected by the ongoing impact of market dislocation; this has led to a charge within trading income of £956 million, compared to a charge of £188 million in 2007. The market dislocation losses largely reflect the impact of continuing mark-to-market adjustments in certain legacy trading portfolios, resulting from the marketwide repricing of liquidity and credit, together with the write-down of a number of asset-backed securities.

Insurance premium income was £18 million lower at £5,412 million compared to £5,430 million in 2007, with life and pensions premiums being £39 million lower at £4,800 million and general insurance premiums £21 million higher at £612 million. The small reduction in life and pensions premiums reflects the impact of the sale of Abbey Life (which accounted for £232 million of the premiums in 2007) and a decrease of £44 million in annuity premiums largely offset by growth in other life and pensions products within the Scottish Widows business. The increase in non-life insurance premiums is due to growth in home insurance income more than offsetting a volume-related decrease in respect of creditor products.

Other operating income was £420 million, or 44 per cent, lower at £532 million compared to £952 million in 2007. The movement in value of in-force business was a reduction of £325 million compared to a reduction of £93 million in 2007, as an improvement in new business income was more than offset by lower income from existing business principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets. There was a reduction of £1 million in operating lease rental income and a reduction of £49 million in car dealership income following the sale of the Dutton Forshaw business in 2007 as well as reductions in other non-fee income.

2007 COMPARED TO 2006

Other income was £2,215 million, or 15 per cent, lower at £12,129 million compared to £14,344 million in 2006.

Fee and commission income was £108 million, or 3 per cent, higher at £3,224 million compared to £3,116 million in 2006. UK current account fees were £41 million higher reflecting growth in added-value account fees partly offset by a reduction in returned cheque fees. Insurance broking income was £19 million higher, driven by improved creditor performance as a result of higher loan protection volumes across the branch network. Card fees were £43 million higher; merchant service charges were higher as a result of growth in the merchant base and interchange income was £20 million higher, in part due to the success of the new Airmiles Duo card. Other UK fees and commissions were £5 million higher at £1,215 million; increases in unit trust and asset management fees, factoring fees and corporate banking fees being largely offset by reduced levels of company registration fees (following the sale of Lloyds TSB Registrars) and other fees. International fees and commissions were unchanged at £132 million.

Fee and commission expense was £38 million, or 6 per cent, lower at £600 million. Increases in account fees and card fees (as a result of business volumes) were more than offset by reductions in fees payable within the insurance businesses.

Net trading income was £3,218 million lower at £3,123 million; £2,411 million lower at £3,570 million excluding volatility. The majority of this decrease arises in the insurance businesses and represents reductions in the gains on policyholder investments that are required to be reported gross in the income statement; the period-on-period decrease is largely matched by a compensating movement within the insurance claims figure. Trading income within the banking businesses was also impacted by the turmoil in global financial markets in the second half of 2007 which led to a reduction of £188 million, this reflected the market wide repricing of instruments for credit and liquidity risks, including those asset-backed securities carried in the Group s trading portfolio.

Insurance premium income was £711 million, or 15 per cent, higher at £5,430 million compared to £4,719 million in 2006, with life and pensions premiums being £720 million higher at £4,839 million and general insurance premiums £9 million lower at £591 million. The increase in life and pensions premiums reflects higher single and regular premiums for the pensions business (including the new corporate pension product) plus the launch of a new protection product.

Other operating income was £146 million, or 18 per cent, higher at £952 million compared to £806 million in 2006. The movement in value of in-force business improved to a reduction of £93 million compared to a reduction of £199 million in 2006, in part due to the non-repetition of the charge arising from the introduction of new FSA valuation rules in 2006. Reductions in operating lease rental income and in income from investment property were more than offset by increases in other non-fee income.

OPERATING EXPENSES

	2008 £m	2007 £m	2006 £m
Administrative expenses:			
Staff:			
Salaries	**2,183**	2,127	2,117
National insurance	**176**	167	161
Pensions, net of pension schemes related credit	**235**	238	165
Other staff costs	**337**	372	298
	2,931	2,904	2,741
Premises and equipment:			
Rent and rates	**318**	304	310
Hire of equipment	**16**	16	15
Repairs and maintenance	**151**	154	165
Other	**165**	145	149
	650	619	639
Other expenses:			
Communications and external data processing	**455**	462	499
Advertising and promotion	**194**	192	184
Professional fees	**229**	279	231
Provision in respect of certain historic US dollar payments	**180**		
Provision for Financial Services Compensation Scheme levy	**122**		
Settlement of overdraft claims		76	
Other	**506**	405	388
	1,686	1,414	1,302
Administrative expenses	**5,267**	4,937	4,682
Depreciation of tangible fixed assets	**648**	594	602
Amortisation of intangible assets	**38**	36	17
Impairment of goodwill	**100**		
Total operating expenses	**6,053**	5,567	5,301
Cost: income ratio (%)*	**61.3**	52.0	47.7

Following changes in age discrimination legislation in the United Kingdom in 2006, the Group ceased to augment the pension entitlement of employees taking early retirement. This change resulted in a credit to the income statement in 2006 of £128 million (2008: £nil; 2007: £nil).

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

2008 COMPARED TO 2007

Operating expenses were £486 million, or 9 per cent, higher at £6,053 million in 2008 compared to £5,567 million in 2007. Operating expenses in both 2008 and 2007 were, however, impacted by a number of individually significant items. In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney s Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices; the Group had provided £180 million in respect of this matter in its 2008 results. The arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit taking institutions involving the Financial Services Compensation Scheme (FSCS) will result in a significant increase in the levies made by the FSCS on the industry. The Group has made a provision of £122 million in respect of its current obligation for the estimated interest cost on the FSCS borrowings. For further information on both items see note 48 to the consolidated financial statements. During 2008, the basis of goodwill allocation in parts of the Asset Finance business has been changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance. The markets in which this unit operates have been affected by the UK economic downturn, which has been characterised by falling demand and increasing arrears at this point of the cycle. This, together with uncertainties over the likely short-term macroeconomic environment, resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million in 2008. For further information see note 23 to the consolidated financial statements. The 2007 results included a charge of £76 million relating to the settlement of overdraft claims during the year, together with related costs. If the provision in respect of certain historic US dollar payments, the provision for the Financial Services Compensation Scheme levy and the impairment of goodwill in 2008 and the settlement of overdraft claims in 2007, are excluded, underlying operating expenses were £160 million, or 3 per cent, higher at £5,651 million in 2008 compared to £5,491 million in 2007, for the following reasons.

Staff costs were £27 million, or 1 per cent, higher at £2,931 million in 2008 compared to £2,904 million in 2007. Salaries were £56 million, or 3 per cent, higher at £2,183 million. There was a small increase in staff numbers which, together with the effect of the annual pay awards, more than offset staff reductions following the sale of businesses during 2007. National insurance costs were £9 million, or 5 per cent, higher at £176 million compared to £167 million in 2007. Pension costs were £3 million, or 1 per cent, lower at £235 million compared to £238 million in 2007; this small reduction arises because an £8 million increase in the cost of contributions to defined contribution pension schemes (which cover all eligible new employees) has been more than offset by an £11 million reduction in the charge in respect of defined benefit schemes (following further increases in asset values and expected returns at the end of 2007). Other staff costs were £35 million, or 9 per cent, lower at £337 million compared to £372 million in 2007; a further increase in costs for agency staff (used to cover project work), has been more than offset by a decrease in redundancy costs as the level of particular restructuring initiatives seen in 2007 has not been repeated in 2008.

Premises and equipment costs were £31 million, or 5 per cent, higher at £650 million in 2008 compared to £619 million in 2007. Rent and rates were £14 million higher, as a result of rent reviews and some new properties taken on. Hire of equipment was unchanged at £16 million and repairs and maintenance costs were £3 million lower at £151 million. Other premises and equipment costs were £20 million higher at £165 million, compared to £145 million in 2007, following an increase in losses on disposal of equipment due to the downturn in the used car market and a lower level of profits on disposal of premises as the number of particular transactions in 2007 was not repeated in 2008; there were also increases in premises management charges.

Other costs were £272 million, or 19 per cent, higher at £1,686 million in 2008 compared to £1,414 million in 2007, although excluding the £180 million provision in respect of certain historic US dollar payments and the £122 million provision for the Financial Services Compensation Scheme levy in 2008 and the charge of £76 million in respect of the settlement of overdraft claims in 2007, other costs in 2008 were £46 million, or 3 per cent, higher at £1,384 million compared to £1,338 million in 2007, for the following reasons.

Other costs were £101 million, or 25 per cent, higher at £506 million compared to £405 million in 2007; this increase reflects increased levels of operational losses, partly due to adverse fraud experience, higher insurance costs as a result of a review of the level of insurance cover held at the end of 2007, a further increase in the charge in respect of deferred acquisition costs in the insurance businesses, in part due to restructuring of certain insurance products, and a general increase in miscellaneous expenditure. Advertising and promotion costs were £2 million, or 1 per cent, higher at £194 million compared to £192 million in 2007, as a further increase in expenditure relating to the Group s sponsorship of the London 2012 Olympics and higher levels of advertising in relation to Corporate business were partly offset by the non-repetition of particular campaigns from 2007. Professional fees were £50 million, or 18 per cent, lower at £229 million compared to £279 million in 2007 as these costs in 2007 included significant expenditure on a number of projects including the transfer of the mortgage lending and deposits of Lloyds TSB Bank plc s subsidiary, Cheltenham & Gloucester plc, into Lloyds TSB Bank plc, and further mortgage securitisations. Communications and external data processing costs were £7 million, or 2 per cent, lower at £455 million compared to £462 million in 2007 as underlying increases in software and telecommunications charges were more than offset by the effect of the businesses sold in 2007, particularly the company registration business.

Depreciation and amortisation was £56 million, or 9 per cent, higher at £686 million compared to £630 million in 2007. There was a £44 million increase in the charge in respect of operating lease assets, reflecting a change in mix of the portfolio towards shorter lived assets, such as motor vehicles, and an increased charge following a review of aircraft residual values. There was a £12 million increase in depreciation of own-use assets, reflecting the recent increased levels of capital expenditure, partly in relation to software.

The cost: income ratio was 61.3 per cent in 2008 compared to 52.0 per cent in 2007.

2007 COMPARED TO 2006

Operating expenses were £266 million, or 5 per cent, higher at £5,567 million compared to £5,301 million in 2006. Operating expenses in 2007 and 2006 were, however, particularly impacted by two items. The 2007 results included a charge of £76 million relating to the settlement of overdraft claims during the year, together with related costs. In 2006, there was a credit to pension costs of £128 million because, following changes in age discrimination legislation, the Group took the decision to cease to augment the pension entitlement of employees taking early retirement. If both the settlement of overdraft claims in 2007 and the pension credit in 2006 are excluded, operating expenses were £62 million, or 1 per cent, higher at £5,491 million in 2007 compared to £5,429 million in 2006.

Staff costs were £163 million, or 6 per cent, higher at £2,904 million. However, excluding the £128 million pension schemes related credit from 2006, staff costs were £35 million, or 1 per cent, higher. Salaries were £10 million higher at £2,127 million; the decrease in costs resulting from the sale of businesses during 2007 and ongoing reductions in staff numbers having been more than offset by annual pay awards and increased bonus and incentive costs. National insurance costs were £6 million, or 4 per cent, higher at £167 million compared to £161 million in 2006. Pension costs were £73 million, or 44 per cent, higher at £238 million compared to £165 million in 2006. Excluding the one-off credit of £128 million from 2006, pension costs in 2007 were £55 million, or 19 per cent, lower than the underlying charge in 2006; this reduction reflected a £55 million reduction in the IAS 19 regular cost resulting from improved asset values at the end of 2006 and increased rates of return in 2007. A small reduction in past service costs was offset by a £7 million increase in defined contribution costs. Other staff costs were £74 million, or 25 per cent, higher at £372 million compared to £298 million in 2006; an increase in costs for agency staff (used to cover specific project work), was combined with a small increase in training costs, an increase in redundancy costs (due to various restructuring initiatives) and general increases in other staff related expenditure.

Premises and equipment costs were £20 million, or 3 per cent, lower at £619 million in 2007 compared to £639 million in 2006. Repairs and maintenance expenditure was £11 million lower in 2007, due to savings on renegotiation of various contracts; other premises and equipment costs were £4 million lower and there was a small reduction in rental costs.

Other costs were £112 million, or 9 per cent, higher at £1,414 million, although excluding the charge of £76 million in respect of the settlement of overdraft claims other costs in 2007 were £36 million, or 3 per cent, higher at £1,338 million. Communications and external data processing costs were £37 million, or 7 per cent, lower at £462 million compared to £499 million in 2006 as a result of efficiency initiatives, successful contract renegotiation and supplier rationalisation. Advertising and promotion costs were £8 million, or 4 per cent, higher at £192 million compared to £184 million in 2006, in part due to increased expenditure relating to the Group s sponsorship of the London 2012 Olympics. Professional fees were £48 million, or 21 per cent, higher at £279 million compared to £231 million in 2006 due to significant expenditure on a number of projects including the transfer of the mortgage lending and deposits of Lloyds TSB Bank plc s subsidiary, Cheltenham & Gloucester plc, into Lloyds TSB Bank plc, and further mortgage securitisations. Other costs were £17 million, or 4 per cent, higher at £405 million compared to £388 million in 2006 as an increase in the charge in respect of deferred acquisition costs in the insurance businesses, reflecting a change in mix of new business and the impact of changes in assumptions, was only partly offset by reductions in stationery and other costs.

Depreciation and amortisation was £11 million, or 2 per cent, higher at £630 million compared to £619 million in 2006. There was a small decrease in the charge in respect of operating lease assets, following a restructuring of the Group s lease arrangements, and a reduction in the charge relating to other premises and equipment; but these decreases were more than offset by an increase of £19 million in the charge in respect of software and other intangible assets, in part reflecting the customer list acquired at the end of 2006.

The cost: income ratio was 52.0 per cent in 2007 compared to 47.7 per cent in 2006.

IMPAIRMENT

	2008	2007	2006
	£m	£m	£m
Impairment losses on loans and advances	**2,876**	1,721	1,560
Other credit risk provisions	**6**	5	(5)
	2,882	1,726	1,555
Impairment of available-for-sale financial assets	**130**	70	
Total impairment charged to income statement	**3,012**	1,796	1,555

	2008	2007	2006
	£m	£m	£m
UK Retail Banking	**1,472**	1,224	1,238
Insurance and Investments	**2**		
Wholesale and International Banking	**1,402**	497	313
Central group items			9
Total charge for impairment losses on loans and advances	**2,876**	1,721	1,560
	%	%	%
Charge for impairment losses on loans and advances as a percentage of average lending	**1.24**	0.84	0.83

2008 COMPARED TO 2007

The impairment charge in the income statement was £1,216 million, or 68 per cent, higher at £3,012 million in 2008 compared to £1,796 million in 2007. This comprised a charge of £2,876 million, compared to a charge of £1,721 million in 2007, in respect of impairment losses on loans and advances, a charge of £130 million, compared to a charge of £70 million in 2007, in respect of the impairment of available-for-sale financial assets and a charge of £6 million, compared to a charge of £5 million in 2007, in respect of other credit risk provisions.

The impairment charge in respect of loans and advances was £1,155 million, or 67 per cent, higher at £2,876 million compared to £1,721 million in 2007.

In UK Retail Banking the charge increased by £248 million, or 20 per cent, to £1,472 million from £1,224 million in 2007, resulting in a charge as a percentage of average lending of 1.22 per cent compared to 1.10 per cent in 2007. This particularly reflects an increase of £149 million in the impairment charge in respect of mortgage lending from £18 million in 2007 to £167 million in 2008 as a result of the impact of reducing house prices and a deterioratiing economic environment in the UK. Increased impairment charges also arose in respect of personal loans and overdrafts (up £100 million, or 15 per cent, from £679 million in 2007 to £779 million in 2008) as a result of higher arrears, resulting in an increase in the impairment charge, expressed as a percentage of average lending, from 5.32 per cent in 2007 to 5.73 per cent in 2008. The impairment charge in respect of credit card outstandings was flat at £526 million in 2008 compared to £527 million in 2007, despite a decrease in average balances, as a result of increased arrears and fraud losses the impairment charge in respect of card lending, expressed as a percentage of average lending, increased from 7.96 per cent in 2007 to 8.12 per cent in 2008.

A charge of £2 million, compared to £nil in 2007, in Insurance and Investments related to the mortgage lending in Scottish Widows Bank.

In Wholesale and International Banking the impairment charge in respect of loans and advances increased by £905 million from £497 million in 2007 to £1,402 million in 2008 and this charge as a percentage of average lending was 1.33 per cent compared to 0.57 per cent in 2007. The charge within Corporate Markets was significantly higher at £939 million in 2008 compared to £165 million in 2007 as a result of a charge of £253 million, compared to a charge of £22 million in 2007, in relation to exposures to assets affected by current capital markets uncertainties, as well as a number of charges in relation to customers affected by the severe economic downturn and to the collapse of certain financial services companies. The impairment charge in Commercial Banking was £89 million, or 90 per cent, higher at £188 million in 2008 compared to £99 million in 2007, again reflecting the impact of the economic downturn; and the charge in Asset Finance was £42 million, or 18 per cent, higher at £270 million in 2008 compared to £228 million in 2007, as a result of higher arrears.

Overall, the Group s charge in respect of impairment losses on loans and advances expressed as a percentage of average lending increased to 1.24 per cent compared to 0.84 per cent in 2007.

A charge of £130 million in 2008, compared to a charge of £70 million in 2007, arose in respect of the impairment of available-for-sale financial assets, largely in relation to certain asset-backed security collateralised debt obligations, although £30 million of the charge in 2008 reflected the write-off of the Group s investment in Bradford & Bingley equity shares.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2007 COMPARED TO 2006

The impairment charge in the income statement was £241 million, or 15 per cent, higher at £1,796 million in 2007 compared to £1,555 million in 2006. This comprised a charge of £1,721 million, compared to a charge of £1,560 million in 2006, in respect of impairment losses on loans and advances, a charge of £70 million, compared to £nil in 2006, in respect of the impairment of available-for-sale financial assets and a charge of £5 million, compared to a credit of £5 million in 2006, in respect of other credit risk provisions.

The impairment charge in respect of loans and advances was £161 million, or 10 per cent, higher at £1,721 million compared to £1,560 million in 2006.

In UK Retail Banking the charge reduced by £14 million, or 1 per cent, to £1,224 million from £1,238 million in 2006, resulting in a charge as a percentage of average lending of 1.10 per cent compared to 1.18 per cent in 2006. For personal loans and overdrafts the charge reduced by £61 million, or 8 per cent, reflecting favourable collections experience and improved quality in new business. The charge for the credit card portfolio increased by £37 million, or 8 per cent, from £490 million in 2006 to £527 million in 2007 following a higher level of write-offs and lower recoveries. There was a charge of £18 million in the mortgage book, compared to £8 million in 2006, reflecting the impact of changes in house price indices and higher write-offs.

In Wholesale and International Banking the charge increased by £184 million, or 59 per cent, from £313 million in 2006 to £497 million in 2007 and the charge as a percentage of average lending was 0.57 per cent compared to 0.39 per cent in 2006. In Corporate Markets the charge was £179 million higher, at £165 million compared to a release of £14 million in 2006; 2006 saw a number of releases, whereas in 2007 there were significant new charges for certain Corporate customers as well as a charge of £28 million in the leasing business resulting from the change in the UK corporation tax rate from 30 per cent to 28 per cent. In Asset Finance the charge was £11 million lower, at £228 million, following a tightening of underwriting criteria. In Commercial Banking the charge was £5 million higher, at £99 million, and in International Banking and other businesses there was a charge of £5 million compared with a release of £6 million in 2006.

Overall, the Group s charge in respect of impairment losses on loans and advances expressed as a percentage of average lending increased to 0.84 per cent compared to 0.83 per cent in 2006.

A charge of £70 million in 2007, compared to £nil in 2006, arose in respect of the impairment of certain asset-backed security collateralised debt obligations held as available-for-sale financial assets.

TAXATION

	2008 £m	2007 £m	2006 £m
UK corporation tax:			
Current tax on profits for the year	**(667)**	(763)	(1,024)
Adjustments in respect of prior years	**(19)**	30	137
	(686)	(733)	(887)
Double taxation relief	**91**	60	195
	(595)	(673)	(692)
Foreign tax:			
Current tax on profits for the year	**(144)**	(98)	(83)
Adjustments in respect of prior years	**4**	3	8
	(140)	(95)	(75)
Current tax charge	**(735)**	(768)	(767)
Deferred tax	**773**	89	(574)
Taxation credit (charge)	**38**	(679)	(1,341)

2008 COMPARED TO 2007

The rate of tax is influenced by the geographic and business mix of profits. The effective rate of tax in 2008 was a negative 4.7 per cent, as a tax credit arose on the profit for the year, compared to an effective rate of tax in 2007 of 17.0 per cent and corporation tax rates of 28.5 per cent in 2008 and 30 per cent in 2007. The effective tax rate is 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 OEICs, being a tax credit of £471 million for 2008 compared to a tax credit of £243 million in 2007. The effective rate in 2007 was also particularly distorted by substantial profits on disposal of businesses, on which no tax charge arose, and the impact on the tax charge of the 2007 Finance Act reduction in the corporation tax rate from 30 per cent to 28 per cent (as a result of which the Group s deferred tax liabilities were remeasured leading to a credit to the Group s tax charge of £110 million). Excluding these items the effective tax rate in 2008 was 33.3 per cent compared to 28.3 per cent in 2007. Of this 5.0 per cent increase in the effective rate, 4.1 per cent is attributable to the impact of the Group s £180 million provision in respect of certain historic US dollar payments, on which no tax relief is assumed; the remainder of the increase in the effective tax rate in 2008 on this adjusted basis reflects normal fluctuations in disallowed and non-taxable items. The Group does not expect the tax rate, excluding the impact of policyholders tax and OEICs, to vary significantly from the average UK corporation tax rate.

2007 COMPARED TO 2006

The effective rate of tax in 2007 was 17.0 per cent, compared to an effective rate of tax in 2006 of 31.6 per cent and corporation tax rates of 30 per cent in both 2007 and 2006. Excluding the tax attributable to UK life insurance policyholder earnings and the Group s interests in OEICs, profits on disposal of businesses and the impact on the tax charge of the 2007 Finance Act reduction in the corporation tax rate, the effective tax rate in 2007 was 28.3 per cent compared to 28.0 per cent in 2006. The increased effective tax rate in 2007 on this adjusted basis reflected normal fluctuations in disallowed and non-taxable items.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

ECONOMIC PROFIT

In pursuit of the Group s aim to maximise shareholder value over time, management has for a number of years used a system of value based management as a framework to identify and measure value creation. Management uses economic profit, a non-GAAP measure, as a measure of performance, and believes that it provides important information for investors, because it captures both growth in investment and return; profit before tax is the comparable GAAP measure used by management. The Group defines economic profit as the earnings on the equity invested in the business less a notional charge for the cost of the equity invested in that business.

The Group s cost of equity is determined as:

risk-free interest rate + (equity risk premium x Lloyds Banking Group plc s beta)

The principal limitations of economic profit as a financial measure are that:

(i) it is reliant on an estimate of the Group s cost of equity, which is itself dependent upon assumptions made for the risk-free interest rate, the equity risk premium and the beta of Lloyds Banking Group plc. The beta is a quantitative measure of the volatility of Lloyds Banking Group plc shares relative to the overall market a beta above 1 indicates that the stock is more volatile than the overall market, whilst a stock with a beta below 1 is less volatile than the overall market; and

(ii) it uses average shareholders equity calculated on an accounting basis as opposed to an economic equity amount, which takes into account the level of risk inherent in the business; the Group is currently developing an economic equity model to address this limitation.

The Group does not attempt to estimate the assumptions on a prospective basis; the assumptions used are:

(a) the yield on the 10 year index for UK government stock as an approximation of the risk-free rate;

(b) an equity risk premium of 3 per cent; and

(c) the beta of Lloyds Banking Group plc s shares based on experience over the last five years.

Lloyds Banking Group recognises that a wide range of approaches for economic profit can be justified and, therefore, believes that its usefulness as a financial measure relies upon a consistent approach, so as not to unnecessarily distort its trend.

Management compensates for both of the above limitations by using a consistent basis of calculation, reviewing the results of the calculation regularly and, to ensure consistency of reporting, only adjusting the cost of capital if it changes significantly. As noted above, the Group is also currently developing its economic equity capabilities, which will address the current limitations. As noted, the principal factor in estimating the cost of equity is the risk-free interest rate. If this rate increases, management will consider raising its estimate of the cost of equity; if the rate falls, management will consider reducing its estimate of the cost of equity. The principal other external market factors considered are equity risk premia and Lloyds Banking Group plc s share price volatility relative to the UK stock market as a whole. Any change to the estimated cost of equity will be disclosed. For the last three years, management has used a cost of equity of 9 per cent to reflect the shareholders minimum required rate of return on equity invested.

Lloyds Banking Group believes that economic profit instils financial discipline in determining investment decisions throughout the Group and that it enables the Group to evaluate alternative strategies objectively, with a clear understanding of the value created by each strategy, and then to select the strategy which creates the greatest value. Awards to senior executives under the Group s annual bonus arrangements are partly determined by the achievement of economic profit targets.

The table below summarises the Group s calculation of economic profit for the years indicated.

	2008 **£m**	2007 £m	2006 £m
Average shareholders equity	**11,016**	11,681	10,531

Profit before tax	**807**	4,000	4,248
Taxation credit (charge)	**38**	(679)	(1,341)
Profit attributable to minority interests	**(26**)	(32)	(104)
Profit attributable to equity shareholders	**819**	3,289	2,803
Less: notional charge for the cost of equity	**(991**)	(1,051)	(948)
Economic profit	**(172**)	2,238	1,855

The notional charge for the cost of equity has been calculated by multiplying average shareholders equity by the cost of equity. The Group s average equity is determined using month-end retained profit and other equity balances.

2008 COMPARED TO 2007

Economic profit decreased to a loss of £172 million in 2008 compared to a profit of £2,238 million in 2007. Profit attributable to equity shareholders decreased by £2,470 million, or 75 per cent, to £819 million; the notional charge on average equity was £60 million lower, as a result of a 6 per cent decrease in average equity to £11,016 million compared to £11,681 million in 2007. The reduction in average equity primarily resulted from profit retentions and increases in share capital being more than offset by dividends paid and temporary mark-to-market adjustments taken to reserves in respect of available-for-sale financial assets.

2007 COMPARED TO 2006

Economic profit increased to £2,238 million in 2007 compared to £1,855 million in 2006. Profit attributable to equity shareholders increased by £486 million, or 17 per cent, to £3,289 million; the notional charge on average equity was £103 million higher, as a result of an 11 per cent increase in average equity to £11,681 million compared to £10,531 million in 2006. The increase in average equity primarily reflected profit retentions, after dividends, over 2006 and 2007.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LINE OF BUSINESS INFORMATION

SUMMARY

As part of the Group s transition to Basel II on 1 January 2008, the Group has updated its capital and liquidity pricing methodology. The main difference in this approach is to allocate a greater share of certain funding costs, previously allocated to the Central group items segment, to the other divisions. To enable meaningful year-on-year comparisons, the segmental analyses for 2007 and 2006 have been restated to reflect these changes.

The impact of IFRS, and in particular the increased use of fair values, has resulted in greater earnings volatility. Profit before tax is analysed below on both a statutory basis and, in order to provide a more comparable representation of business performance, a basis which separately discloses this volatility, which arises solely within the Insurance and Investments business. See page 38 for a description of volatility and its most significant limitations. The results of the businesses are set out below:

	Profit before tax (statutory)			**Profit before tax (excluding volatility)**		
	2008 £m	2007# £m	2006# £m	**2008 £m**	2007# £m	2006# £m
UK Retail Banking	**1,674**	1,644	1,529	**1,674**	1,644	1,529
Insurance and Investments	**(309)**	655	1,194	**908**	1,155	784
Wholesale and International Banking	**(6)**	1,713	1,612	**(6)**	1,713	1,612
Central group items	**(552)**	(12)	(87)	**(552)**	(12)	(87)
Profit before tax, excluding volatility				**2,024**	4,500	3,838
Volatility				**(1,217)**	(500)	410
Profit before tax	**807**	4,000	4,248	**807**	4,000	4,248

UK RETAIL BANKING

	2008 £m	2007# £m	2006# £m
Net interest income	**4,110**	3,695	3,622
Other income	**1,766**	1,797	1,621
Total income	**5,876**	5,492	5,243
Operating expenses	**(2,730)**	(2,624)	(2,476)
Trading surplus	**3,146**	2,868	2,767
Impairment	**(1,472)**	(1,224)	(1,238)
Profit before tax	**1,674**	1,644	1,529
Cost:income ratio	**46.5%**	47.8%	47.2%
Total assets (year end)	**£127,502m**	£115,012m	£108,381m

No volatility arises within UK Retail Banking and so these results are both statutory and excluding volatility.

restated, see above.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED TO 2007

Profit before tax from UK Retail Banking increased by £30 million, or 2 per cent, to £1,674 million in 2008 compared to £1,644 million in 2007.

Net interest income was £415 million, or 11 per cent, higher at £4,110 million in 2008 compared with £3,695 million in 2007, reflecting both an increase in average interest-earning assets and an improvement in the net interest margin. Average interest-earning assets were £9,234 million, or 8 per cent, higher at £120,128 million in 2008 compared to £110,894 million in 2007 as a result of lending growth, particularly within the mortgage business. Average mortgage balances were £8,652 million higher in 2008. Gross new mortgage lending for the Group totalled £27,767 million, compared to £29,431 million in 2007; net new lending totalled £10,914 million, compared to £6,647 million in 2007, resulting in a market share of net new mortgage lending of 27.5 per cent, compared to 6.2 per cent in 2007. Average balances in respect of other personal lending were £20,138 million compared with £19,426 million in 2007. Average credit card balances in 2008 were 2 per cent lower at £6,477 million compared to £6,619 million in 2007, whilst balances on personal loans and overdrafts were 7 per cent higher at £13,661 million in 2008. Overall margins in UK Retail Banking improved by 9 basis points as a result of wider margins within the unsecured personal lending business and on new mortgages.

Other income was £31 million, or 2 per cent, lower at £1,766 million compared to £1,797 million in 2007. Higher fees and commissions receivable as a result of growth in added-value current accounts and card services were more than offset by lower creditor insurance commissions and the impact of changes in product design leading to a greater proportion of earnings being recognised as net interest income rather than other income.

Operating expenses were £106 million higher at £2,730 million in 2008 compared with £2,624 million in 2007; in 2008 a provision of £119 million, compared to £nil in 2007, was made in respect of the Financial Services Compensation Scheme levy whilst in 2007 operating expenses included £76 million for the settlement of overdraft claims. Excluding these items, operating expenses were £63 million, or 2 per cent, higher at £2,611 million. The Group has continued to benefit from the recent investment in reducing the levels of administration and processing work carried out in branches. This has enabled the Group to increase its focus on meeting the needs of its customers and has supported further improved productivity in the branch network sales effort. These initiatives have supported a further improvement in the retail banking cost:income ratio to 46.5 per cent from 47.8 per cent in 2007.

The impairment charge on loans and advances of £1,472 million in 2008 was £248 million, or 20 per cent, higher than the £1,224 million impairment charge in 2007. The charge in respect of personal loans and overdrafts was £100 million, or 15 per cent, higher at £779 million compared to £679 million in 2007 and represented 5.73 per cent of average lending, compared to 5.32 per cent in 2007; and the charge in respect of card balances was £1 million lower at £526 million compared with £527 million in 2007. The impairment charge in Mortgages was £167 million, compared to £18 million in 2007, or 17 basis points of average mortgage lending. The most significant factors in the increase in the mortgage impairment charge during 2008 were the fall in the house price index and the deterioration in economic conditions in the UK.

2007 COMPARED TO 2006

Profit before tax from UK Retail Banking increased by £115 million, or 8 per cent, to £1,644 million in 2007 compared to £1,529 million in 2006. Profit before tax included the cost of the settlement of overdraft claims of £76 million in 2007, compared to £nil in 2006; excluding this item, profit before tax in 2007 of £1,720 million was £191 million, or 12 per cent, higher than £1,529 million in 2006.

Net interest income was £73 million, or 2 per cent, higher at £3,695 million in 2007 compared with £3,622 million in 2006. Average interest-earning assets were £5,959 million, or 6 per cent, higher at £110,894 million in 2007 compared to £104,935 million in 2006. Average mortgage balances were £6,462 million higher in 2007. Gross new mortgage lending for the Group totalled £29,431 million, compared to £27,599 million in 2006; net new lending totalled £6,647 million, compared to £6,957 million in 2006, resulting in a market share of net new mortgage lending of 6.2 per cent, compared to 6.3 per cent in 2006. Average balances in respect of other personal lending were £266 million lower reflecting a slow down in consumer demand, particularly with regard to credit cards. Credit card balances at 31 December 2007 were 4 per cent lower at £6,584 million compared to £6,877 million at 31 December 2006, whilst period end balances on personal loans were 1 per cent higher at £11,238 million at the end of 2007. Credit balances on savings and investment accounts at 31 December 2007 were 8 per cent higher at £82,081 million compared to £75,661 million at 31 December 2006. The effect of volume growth was, however, partly offset by a 12 basis point decrease in the net interest margin as a result of competitive pressures and an adverse mix effect, as most of the asset growth has been in the relatively lower margin mortgage sector.

Other income was £176 million, or 11 per cent, higher at £1,797 million compared to £1,621 million in 2006. The increase arose from growth in fee-earning added-value current accounts and income from debit cards as well as higher insurance commissions, partially offset by lower income from mortgages following changes in the structure of fees charged on closing a mortgage account and lower late payment charges on credit cards. There has also been an increase in wealth management fee income.

Operating expenses were £148 million higher at £2,624 million in 2007 compared with £2,476 million in 2006; this comparison includes the cost of the settlement of overdraft claims of £76 million which was recorded in 2007. Excluding this item, operating expenses were £72 million, or 3 per cent, higher at £2,548 million. Improvements had been made in the rationalisation of back office operations to improve efficiency and the Group continued to increase the proportion of front office to back office staff in the branch network. The cost:income ratio was 47.8 per cent, compared to 47.2 per cent in 2006, or 46.4 per cent excluding the cost of the settlement of overdraft claims.

The impairment charge on loans and advances of £1,224 million was £14 million, or 1 per cent, lower than the £1,238 million in 2006. The charge in respect of personal loans and overdrafts was £61 million, or 8 per cent, lower at £679 million compared to £740 million in 2006 and represented 5.32 per cent of average lending, compared to 5.85 per cent in 2006; and the charge in respect of card balances was £37 million, or 8 per cent, higher at £527 million compared with £490 million in 2006. The impairment charge in Mortgages was £18 million, compared to £8 million in 2006, or 2 basis points of average mortgage lending.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE AND INVESTMENTS

The Group s Insurance and Investments activities comprise the life, pensions and OEICs businesses of Scottish Widows, general insurance underwriting and broking, Scottish Widows Bank and Scottish Widows Investment Partnership. The Group sold Abbey Life in the second half of 2007.

In addition to presenting Insurance and Investments results prepared in accordance with IFRS, all monthly financial reporting to the group executive committee and board presents separately the results of these businesses before volatility. The information set out below, therefore, presents the information both in accordance with applicable accounting standards (statutory) and on a basis which excludes volatility (excluding volatility). Further discussion on the Group s use of volatility is provided in Operating and financial review and prospects Line of business information Volatility .

	Statutory			Excluding volatility		
	2008	2007#	2006#	**2008**	2007#	2006#
	£m	£m	£m	**£m**	£m	£m
Net interest income	**598**	363	(86)	**589**	356	(55)
Other income	**(3,101)**	8,197	10,487	**(1,875)**	8,704	10,046
Total income	**(2,503)**	8,560	10,401	**(1,286)**	9,060	9,991
Insurance claims	**2,859**	(7,522)	(8,569)	**2,859**	(7,522)	(8,569)
Total income, net of insurance claims	**356**	1,038	1,832	**1,573**	1,538	1,422
Operating expenses	**(663)**	(655)	(638)	**(663)**	(655)	(638)
Trading surplus	**(307)**	383	1,194	**910**	883	784
Impairment	**(2)**			**(2)**		
Profit on sale of businesses		272			272	
Profit before tax, excluding volatility				**908**	1,155	784
Volatility				**(1,217)**	(500)	410
(Loss) profit before tax	**(309)**	655	1,194	**(309)**	655	1,194
Further analysis of other income:						
Net fee and commission expense	**(124)**	(94)	(125)	**(124)**	(94)	(125)
Net trading income	**(8,314)**	2,603	5,668	**(7,667)**	3,050	5,308
Insurance premium income	**5,412**	5,430	4,719	**5,412**	5,430	4,719
Other operating income	**(75)**	258	225	**504**	318	144
Other income, excluding volatility				**(1,875)**	8,704	10,046
Volatility				**(1,226)**	(507)	441
Other income	**(3,101)**	8,197	10,487	**(3,101)**	8,197	10,487
Analysis by area of business of profit before tax						
Life, pensions and OEICs	**(582)**	511	897	**632**	1,004	505
General insurance	**231**	103	267	**234**	110	249
Scottish Widows Investment Partnership	**42**	41	30	**42**	41	30
Profit before tax, excluding volatility				**908**	1,155	784
Volatility				**(1,217)**	(500)	410

(Loss) profit before tax	**(309)**	655	1,194	**(309)**	655	1,194

restated, see page 28.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED TO 2007

Profit before tax from the Group s Insurance and Investments business was £964 million lower at a loss of £309 million compared to a profit of £655 million in 2007. The Group believes that the Insurance and Investments business is affected by volatility arising from market movements (see Operating and financial review and prospects Line of business information Volatility). Profit before tax excluding volatility was £247 million, or 21 per cent, lower at £908 million in 2008 compared to £1,155 million in 2007; profit before tax in 2007 also included £272 million profit on the disposal of Abbey Life at the end of September 2007.

Net interest income was £235 million higher at £598 million in 2008 compared to £363 million in 2007. This increase is primarily as a result of a further decrease of £229 million in the amounts payable to unitholders in those OEICs included in the consolidated results of the Group.

Other income was £11,298 million lower at a deficit of £3,101 million in 2008 compared to income of £8,197 million in 2007. Net fee and commission expense was £30 million, or 32 per cent, higher at £124 million in 2008 compared to £94 million in 2007; a decrease in fees receivable following the disposal of Abbey Life and a decrease in insurance broking fee income were only partly offset by increased unit trust management fee income and a reduction in asset management fees payable. Net trading income was £10,917 million lower at a loss of £8,314 million in 2008 compared to gains of £2,603 million in 2007, reflecting substantial losses on policyholder investments as a result of the poor market performance; this period-on-period decrease is largely matched by a compensating movement within the insurance claims figure. Insurance premium income was £18 million lower at £5,412 million in 2008 compared to £5,430 million in 2007, with life and pensions premiums being £39 million lower as a reduction of £232 million following the sale of Abbey Life has been offset by growth in Scottish Widows as a result of the increased level of business written under contracts categorised as insurance. Other operating income was £333 million lower at a deficit of £75 million in 2008, compared to income of £258 million in 2007, as a result of adverse movements in the value of in-force business.

Operating expenses were £8 million, or 1 per cent, higher at £663 million in 2008 compared to £655 million in 2007. A reduction of £31 million as a result of the disposal of Abbey Life in 2007 and a decrease in professional and other fees related to project work were more than offset by increased staff costs and a higher net charge in respect of deferred acquisition costs as a result of an increasing proportion of new business being accounted for as insurance contracts.

The performances of the life, pensions and OEICs business and the general insurance business are discussed separately below, on pages 32 to 34.

2007 COMPARED TO 2006

Profit before tax from the Group s Insurance and Investments business was £539 million, or 45 per cent, lower at £655 million compared to £1,194 million in 2006. Profit before tax excluding volatility was £371 million, or 47 per cent, higher at £1,155 million in 2007 compared to £784 million in 2006. Profit before tax in 2007 also included £272 million profit on the disposal of Abbey Life at the end of September 2007.

Net interest income was £411 million higher at £356 million in 2007 compared to a net expense of £55 million in 2006. This increase was primarily as a result of a decrease in the amounts payable to unitholders in those OEICs included in the consolidated results of the Group together with an increase in the level of interest income on cash deposit investments held in the long-term business and policyholder funds.

Other income was £2,290 million, or 22 per cent, lower at £8,197 million in 2007 compared to £10,487 million in 2006; excluding volatility, other income was £1,342 million, or 13 per cent, lower at £8,704 million in 2007 compared to £10,046 million in 2006. Net fee and commission expense was £31 million, or 25 per cent, lower at £94 million in 2007 compared to £125 million in 2006 partly reflecting an increase in general insurance broking income. Net trading income was £3,065 million, or 54 per cent, lower at £2,603 million in 2007 compared to £5,668 million in 2006, reflecting fluctuations in the level of investment returns within the long-term business funds. Insurance premium income was £711 million, or 15 per cent, higher at £5,430 million in 2007 compared to £4,719 million in 2006, of which life and pensions premiums were £720 million higher as a result of the increased level of business written under contracts categorised as insurance. Other operating income was £33 million, or 15 per cent, higher at £258 million in 2007 compared to £225 million in 2006.

Operating expenses were £17 million, or 3 per cent, higher at £655 million in 2007 compared to £638 million in 2006. The reduction in staff costs resulting from a year-on-year reduction in staff numbers has been offset by the impact of annual salary increases, a higher net charge in respect of amortisation of deferred acquisition costs and an increased charge for depreciation and amortisation.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LIFE, PENSIONS AND OEICS

The table below shows the Present Value of New Business Premiums (PVNBP) which 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 both the performance and the profitability of the business this is calculated as the value of single premiums plus the discounted present value of future expected regular premiums. There are three main distribution channels for the sale of the Group s life, pension and OEIC products and the tables below show the relative importance of each.

Present value of new business premiums (PVNBP)	**2008 £m**	2007 £m	2006 £m
Life and pensions:			
Protection	**997**	960	232
Savings and investments	**437**	913	1,300
Individual pensions	**2,125**	2,073	2,219
Corporate and other pensions	**2,482**	2,141	1,961
Retirement income	**939**	1,044	960
Managed fund business	**217**	486	348
Life and pensions	**7,197**	7,617	7,020
OEICs	**2,897**	2,807	2,720
Life, pensions and OEICs	**10,094**	10,424	9,740
Single premium business	**7,346**	8,375	7,321
Regular premium business	**2,748**	2,049	2,419
Life, pensions and OEICs	**10,094**	10,424	9,740
Bancassurance	**4,247**	4,096	3,421
Independent financial advisers	**5,367**	5,817	5,706
Direct	**480**	511	613
Life, pensions and OEICs	**10,094**	10,424	9,740

2008 COMPARED TO 2007

Overall life, pensions and OEICs sales were £330 million, or 3 per cent, lower at £10,094 million in 2008 compared to £10,424 million in 2007, for the following reasons.

Life and pension sales (including Managed fund business) were £420 million, or 6 per cent, lower at £7,197 million in 2008 compared with £7,617 million in 2007. Protection sales were £37 million, or 4 per cent, higher at £997 million compared to £960 million in 2007, but Savings and investment sales were £476 million lower at £437 million compared to £913 million in 2007, partly due to decreased Flexible Option Bond sales following changes in tax legislation which made such bonds less attractive to investors. Individual pension sales were £52 million higher at £2,125 million in 2008 compared to £2,073 million in 2007 as the negative impact of difficult market conditions were more than offset by the sales of the Retirement Account product. Corporate and other pension sales were £341 million higher at £2,482 million compared to £2,141 million in 2007 as continued product development has helped Scottish Widows to attract a number of large corporate pension schemes. Retirement income sales are £105 million lower at £939 million in 2008 compared to £1,044 million in 2007, as current market conditions have made annuity products unattractive; and Managed fund business sales were £269 million lower at £217 million compared to £486 million in 2008, again as a result of adverse market conditions.

OEICs sales increased by £90 million, or 3 per cent, to £2,897 million in 2008 compared to £2,807 million in 2007 as sales growth through the Wealth Management business has more than offset a decrease in sales elsewhere within the Bancassurance channel, as a result of a fall in consumer confidence in the investment market.

By distribution channel, Bancassurance sales were £151 million, or 4 per cent, higher at £4,247 million in 2008 compared to £4,096 million in 2007 whereas sales via independent financial advisers were £450 million, or 8 per cent, lower at £5,367 million in 2008 compared to £5,817 million in 2007.

Loss before tax, on a statutory basis, from life, pensions and OEICs was £582 million in 2008 compared to a profit of £511 million in 2007. Excluding volatility, profit before tax was £372 million, or 37 per cent, lower at £632 million in 2008 compared to £1,004 million in 2007. Profit before tax in 2007 also included the £272 million profit on disposal of Abbey Life and £135 million of profits, excluding volatility, of Abbey Life up to the date of sale; adjusting for these items profit before tax, excluding volatility, of £632 million in 2008 was £35 million, or 6 per cent, higher than £597 million in 2007 as growth in new business profit, reflecting sales growth in insurance-accounted products, has been partly offset by reduced existing business profits principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2007 COMPARED TO 2006

Overall life, pensions and OEICs sales were £684 million, or 7 per cent, higher at £10,424 million in 2007 compared to £9,740 million in 2006.

The majority of the growth was in life and pension sales (including Managed fund business) which were £597 million, or 9 per cent, higher at £7,617 million in 2007 compared with £7,020 million in 2006. Key growth areas in 2007 were within Bancassurance sales, driven by the introduction of underwriting the life element of the creditor and insurance protection products and the launch of the Protection for Life proposition. Additionally, corporate pension sales were £180 million, or 9 per cent, higher reflecting increased incremental premiums in 2007. These increases were, however, in part offset by a decrease of £387 million in Savings and investments sales largely due to a sharp decline in IFA Flexible Option Bond sales following property fund restrictions and increasing competition in the marketplace.

OEICs sales increased £87 million, or 3 per cent, in 2007 to £2,807 million compared to £2,720 million in 2006. The growth in OEICs sales reflects increased sales capabilities within the Bancassurance channel and, in particular, continued development of the relationships with the Community Banking and Wealth Management businesses within UK Retail Banking.

By distribution channel, Bancassurance sales were £675 million, or 20 per cent, higher at £4,096 million in 2007 compared to £3,421 million in 2006, as a result of continuing development of the relationships with the Community Banking and Wealth Management businesses. Sales via independent financial advisers were £111 million, or 2 per cent, higher at £5,817 million in 2007 compared to £5,706 million in 2006.

Profit before tax, on a statutory basis, from life, pensions and OEICs was £386 million, or 43 per cent, lower at £511 million in 2007 compared to £897 million in 2006. Excluding volatility, profit before tax was £499 million, or 99 per cent, higher at £1,004 million in 2007 compared to £505 million in 2006. Profit before tax in 2007 included £272 million profit on disposal of Abbey Life. A slight reduction in new business profit resulted from a change in the mix of investment products sold through Bancassurance towards non-embedded value accounted products; however this was offset by increased existing business profit, partly reflecting a reduction in adverse assumption changes compared to 2006, and an improved expected return on shareholders net assets.

GENERAL INSURANCE

The results of the general insurance business are set out below.

	Statutory			Excluding volatility		
	2008	2007#	2006#	**2008**	2007#	2006#
	£m	£m	£m	**£m**	£m	£m
Net interest income	**6**	5	30	**6**	5	30
Other income	**579**	554	594	**582**	561	576
Total income	**585**	559	624	**588**	566	606
Insurance claims	**(193)**	(302)	(200)	**(193)**	(302)	(200)
Total income, net of insurance claims	**392**	257	424	**395**	264	406
Operating expenses	**(161)**	(154)	(157)	**(161)**	(154)	(157)
Profit before tax, excluding volatility				**234**	110	249
Volatility				**(3)**	(7)	18
Profit before tax	**231**	103	267	**231**	103	267

	2008	2007	2006
	£m	£m	£m

Premium income from underwriting (net of reinsurance):			
Home	**441**	418	407
Creditor	**163**	164	180
Other	**8**	9	13
	612	591	600
Commissions from insurance broking:			
Creditor	**428**	510	468
Home	**50**	50	59
Other	**71**	88	102
	549	648	629

restated, see page 28.

within the analysis of commissions from insurance broking, profit share receivable has been allocated across product groups, whereas it was previously allocated to other. Comparative figures have been restated accordingly.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED TO 2007

Profit before tax, on a statutory basis, from the Group s general insurance operations was £128 million, or 124 per cent, higher at £231 million in 2008 compared to £103 million in 2007. Excluding volatility, profit before tax was £124 million, or 113 per cent, higher at £234 million in 2008 compared to £110 million in 2007.

Net interest income was £1 million, or 20 per cent, higher at £6 million in 2008 compared to £5 million in 2007.

Other income, on a statutory basis, was £25 million, or 5 per cent, higher at £579 million in 2008 compared to £554 million in 2007. Insurance broking commissions receivable were £99 million, or 15 per cent, lower at £549 million in 2008 compared to £648 million in 2007; home insurance commissions were flat but creditor commissions fell in line with reduced new loan volumes. Underwriting income, net of reinsurance, was £21 million, or 4 per cent, higher at £612 million in 2008 compared to £591 million in 2007; home insurance premiums were 6 per cent higher reflecting the success of the Home Solutions product. Fees and commissions payable were £87 million, or 13 per cent, lower at £605 million in 2008 compared to £692 million in 2007; this largely reflects reduced creditor insurance sales volumes.

Insurance claims expense was £109 million, or 36 per cent, lower at £193 million in 2008 compared to £302 million in 2007 largely as a result of the non-repetition of the £113 million increase in weather related claims in 2007, resulting from storms in January 2007 and severe flooding in June and July 2007 in the UK.

Operating expenses were £7 million, or 5 per cent, higher at £161 million in 2008 compared to £154 million in 2007 reflecting increases in staff costs and other administration charges.

2007 COMPARED TO 2006

Profit before tax, on a statutory basis, from the Group s general insurance operations was £164 million, or 61 per cent, lower at £103 million in 2007 compared to £267 million in 2006. Excluding volatility, profit before tax was £139 million, or 56 per cent, lower at £110 million in 2007 compared to £249 million in 2006.

Net interest income was £25 million lower at £5 million in 2007 compared to £30 million in 2006.

Other income, on a statutory basis, was £40 million, or 7 per cent, lower at £554 million in 2007 compared to £594 million in 2006. Insurance broking commissions receivable were £19 million, or 3 per cent, higher at £648 million in 2007 compared to £629 million in 2006; this was driven primarily by improved Creditor performance (up £42 million in 2007) and reflected higher loan protection sales volumes across the UK Retail Banking branch network. Underwriting income, net of reinsurance, was £9 million, or 2 per cent, lower at £591 million in 2007 compared to £600 million in 2006; increased income in respect of home insurance policies was more than offset by reductions in respect of creditor protection products, partly due to lower average card balances. Fees and commissions payable were £28 million, or 4 per cent, higher at £692 million in 2007 compared to £664 million in 2006; this largely reflected fluctuations in branch network sales volumes.

Insurance claims expense was £102 million, or 51 per cent, higher at £302 million in 2007 compared to £200 million in 2006 largely as a result of a £113 million increase in weather related claims, resulting from storms in January 2007 and severe flooding in June and July 2007 in the UK.

Operating expenses were £3 million, or 2 per cent, lower at £154 million in 2007 compared to £157 million in 2006 reflecting continued focus on improving operational costs and processing efficiency.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WHOLESALE AND INTERNATIONAL BANKING

	2008 **£m**	2007# £m	2006# £m
Net interest income	**3,303**	2,409	2,149
Other income	**829**	1,773	2,035
Total income	**4,132**	4,182	4,184
Operating expenses	**(2,630)**	(2,282)	(2,264)
Trading surplus	**1,502**	1,900	1,920
Impairment	**(1,508)**	(572)	(308)
Profit on sale of businesses		385	
(Loss) profit before tax	**(6)**	1,713	1,612
Cost:income ratio	**63.6**%	54.6%	54.1%
Total assets (year end)	**£238,832m**	£163,294m	£147,836m

No volatility arises within Wholesale and International Banking and so these results are both statutory and excluding volatility.

restated, see page 28.

2008 COMPARED TO 2007

In 2008 Wholesale and International Banking recorded a loss before tax of £6 million compared with a profit before tax of £1,713 million in 2007. Included within the loss before tax in 2008 was a provision of £180 million in respect of certain historic US dollar payments and goodwill impairment of £100 million. The profit before tax in 2007 was positively impacted by the profit on sale of businesses of £385 million (principally relating to Lloyds TSB Registrars) and included profit before tax of £28 million in respect of those businesses. Excluding these items, profit before tax in 2008 was £274 million which was £1,026 million, or 79 per cent, lower than £1,300 million in 2007, for the following reasons.

Net interest income was £894 million, or 37 per cent, higher at £3,303 million compared to £2,409 million in 2007. This increase reflected growth in interest-earning assets in Corporate Markets, Commercial Banking and International Banking. Average interest-earning assets were £22,547 million, or 17 per cent, higher at £158,254 million. Excluding the fine margin reverse repurchase agreement balances from both years, the increase was £24,891 million. The net interest margin, again excluding the fine margin reverse repurchase agreement balances, increased by 27 basis points, as a widening of margins within Corporate Markets, in part as a result of changes in funding arrangements, and Asset Finance was partly offset by decreased margins in Commercial Banking, where growth has been in lower margin secured products.

Other income was £944 million, or 53 per cent, lower at £829 million compared to £1,773 million in 2007. Other income in 2007 included £129 million arising from businesses sold during that year. Excluding this amount, other income was £815 million lower than in 2007; the significant reduction in Corporate Market s other income (£936 million lower), primarily as a result of the recent market turmoil, was partially offset by increases in Commercial Banking (£34 million, or 8 per cent, higher), Asset Finance (£40 million, or 9 per cent, higher) and International Banking (£22 million, or 12 per cent, higher).

Operating expenses were £348 million, or 15 per cent, higher at £2,630 million in 2008 compared to £2,282 million in 2007. In 2007, operating expenses included £130 million arising within businesses sold during that year, and in 2008, operating expenses included £100 million of goodwill impairment in respect of the Group s asset finance business and a provision of £180 million in respect of certain historic US dollar payments. Excluding these amounts, operating expenses increased £198 million, or 9 per cent. This increase reflects the continued investment in the Group s people and infrastructure, particularly within Corporate Markets.

The impairment charge in 2008 totalled £1,508 million, compared to £572 million in 2007, an increase of £936 million. The charge in respect of loans and advances increased by £905 million, from £497 million in 2007 to £1,402 million in 2008 and the charge as a percentage of average lending was 1.33 per cent compared to 0.57 per cent in 2007. In Corporate Markets the charge was £774 million higher, at £939 million compared to £165 million in 2007; the significant increase reflects the economic slowdown in the UK and the impact of a number of high profile financial services company collapses. In Commercial Banking the charge was £89 million, or 90 per cent, higher, at £188 million; in Asset Finance the charge was £42 million, or 18 per cent, higher, at £270 million; and in International Banking there was a charge of £6 million compared with a release of £2 million in 2007. In addition, a charge of £100 million in 2008 (2007: £70 million) arose in respect of the impairment of available-for-sale financial assets.

At 31 December 2008, Lloyds Banking Group s Corporate Markets exposure to certain categories of assets the values of which have been affected by the ongoing capital markets uncertainties was as described below:

Asset Backed Security CDOs (ABS CDOs) and monoline Credit Default Swap (CDS) exposure: Corporate Markets had no direct exposure to US sub-prime ABS and limited indirect exposure through ABS CDOs. During 2008, the market value of the Group s holdings in ABS CDOs reduced and, as a result, Corporate Markets took an income statement charge of £92 million. Corporate Markets had no exposure to mezzanine ABS CDOs. In addition, Corporate Markets had £1,867 million, compared to £1,861 million at 31 December 2007, of ABS CDOs which remain fully cash collateralised by major global financial institutions.

At 31 December 2008, Corporate Markets had fair value exposure to one monoline financial guarantor in the form of CDS protection bought against a £256 million collateralised loans obligation. The exposure on this CDS was £10 million, following a £28 million adverse credit valuation adjustment. A restructuring of the Group s other monoline hedged ABS CDO has eliminated any reliance on the financial guarantor and has resulted in a much improved risk profile on a reduced holding of £128 million included in loans and advances. Credit valuation adjustments and restructuring costs related to the cancelled CDS in the amount of £275 million were recognised in the income statement.

Structured Investment Vehicles (SIV): During 2008 Corporate Markets wrote down the value of its SIV exposures by £95 million. Corporate Markets has no residual exposure to SIV Capital Notes. Additionally, at 31 December 2008 Corporate Markets had a commercial paper back up liquidity facility totalling £22 million, compared to £370 million at 31 December 2007.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Financial instruments held at fair value through profit or loss: During 2008, Corporate Markets also saw a reduction in profit before tax of £653 million (excluding the £303 million described above due to valuation and restructuring costs relating to CDS) as a result of the impact of mark-to-market adjustments in certain legacy trading portfolios, reflecting the marketwide repricing of liquidity and credit.

At 31 December 2008 the trading portfolio contained £33 million of indirect exposure to US sub-prime mortgages and ABS CDOs. This super senior exposure remains protected by note subordination.

Available-for-sale financial assets: At 31 December 2008, the Group s portfolio of available-for-sale financial assets totalled £55,707 million, compared to £20,196 million at 31 December 2007, of which £55,364 million, compared to £19,662 million at 31 December 2007, were held in Corporate Markets. This increase largely reflects the Group s decision to substantially increase, for liquidity purposes, its holdings of treasury and Government guaranteed securities over the HBOS acquisition period. The available-for-sale financial assets comprise £6,273 million ABS in Cancara, the Group s hybrid Asset Backed Commercial Paper conduit, £2,917 million Student Loan ABS, predominantly guaranteed by the US Government, £11,747 million Government bonds and short-dated bank commercial paper, £29,142 million treasury bills and other eligible bills and £5,285 million major bank senior paper and high quality ABS. Temporary mark-to-market adjustments are required to be taken through reserves. During 2008, a net £2,023 million reserves adjustment, which has no impact on the Group s capital ratios, has been made to reflect a reduction in the value of available-for-sale financial assets.

Impairment of available-for-sale financial assets: Gross impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement during 2008 totalled £130 million, compared to £70 million during 2007, of which £100 million relate to Corporate Markets, compared to £70 million during 2007.

Cancara: Total exposures in Cancara were £12,615 million at 31 December 2008, comprising £6,273 million ABS in available-for-sale financial assets and £6,342 million in loans and advances to customers. Cancara is fully consolidated in the Group s accounts. At 31 December 2008, the ABS in Cancara were 91.8 per cent and 94.2 per cent Aaa/AAA rated by Moody s and Standard & Poor s respectively, and there was no exposure either directly or indirectly to sub-prime US mortgages within the ABS portfolio. All non AAA rated ABS have been funded by the Group. At 31 December 2008 loans and advances to customers included no US sub-prime mortgage exposure.

Leveraged finance underwriting commitments: At 31 December 2008, Corporate Markets not yet syndicated leveraged loan underwriting commitments amounted to £931 million, compared to £756 million at 31 December 2007, of which £438 million were originated before the current market uncertainties. All of the underlying assets are performing satisfactorily.

The Group s exposures to categories of assets, the value of which has been affected by the ongoing capital markets uncertainties, have increased significantly following the acquisition of HBOS.

2007 COMPARED TO 2006

Profit before tax from Wholesale and International Banking was £101 million, or 6 per cent, higher at £1,713 million in 2007 compared to £1,612 million in 2006. However, in 2007 profit before tax was particularly impacted by the profit on sale of businesses of £385 million (principally relating to Lloyds TSB Registrars) and by turbulence in global financial markets which reduced profit before tax by £280 million. Excluding both of these items, profit before tax in 2007 was £1,608 million which was £4 million lower than 2006.

Net interest income was £260 million, or 12 per cent, higher at £2,409 million compared to £2,149 million in 2006. This increase reflected growth in customer lending and customer deposits in Corporate Markets and Commercial Banking. Average interest-earning assets were £13,132 million, or 11 per cent, higher at £135,707 million. Excluding the fine margin reverse repurchase agreement balances from both years, the increase was £14,602 million. The net interest margin, again excluding the fine margin reverse repurchase agreement balances, decreased by 2 basis points, as a widening of margins within Corporate Markets, in part as a result of changes in funding arrangements, was offset by decreased margins in Commercial Banking, where growth has been in the most competitive products, and in Asset Finance.

Other income was £262 million, or 13 per cent, lower at £1,773 million compared to £2,035 million in 2006; of this movement a decrease of £188 million is attributable to the impact of the market turbulence, excluding which other income decreased by £74 million, or 4 per cent. Increases in banking and transactional income were offset by a reduced level of company registration fees (following the sale of Lloyds TSB Registrars at the end of September 2007) and the impact of changes in funding arrangements.

Operating expenses were £18 million, or 1 per cent, higher at £2,282 million in 2007 compared to £2,264 million in 2006. The increase reflected continued staff investment particularly in the Corporate Markets and Commercial Banking businesses, offset by improvements in the management of day-to-day operating costs.

The impairment charge in 2007 totalled £572 million, of which £92 million is attributable to the impact of market turbulence, compared to £308 million in 2006, an increase of £264 million, or 86 per cent. The charge in respect of loans and advances increased by £184 million, or 59 per cent, from £313 million in 2006 to £497 million in 2007 and the charge as a percentage of average lending was 0.57 per cent compared to 0.39 per cent in 2006. In Corporate Markets the charge was £179 million higher, at £165 million compared to a release of £14 million in 2006; there were significant new charges for certain Corporate customers as well as a charge of £28 million in the leasing business resulting from the change in the UK corporation tax rate from 30 per cent to 28 per cent in 2007, whereas there were net releases in 2006. In Commercial Banking the charge was £5 million higher, at £99 million, and in Asset Finance the charge was £11 million lower, at £228 million, following a tightening of underwriting criteria. In International Banking and other businesses there was a charge of £5 million compared with a release of £6 million in 2006. In addition, a charge of £70 million in 2007 (2006: £nil) arose in respect of the impairment of available-for-sale financial assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CENTRAL GROUP ITEMS

	2008 **£m**	2007# £m	2006# £m
Net interest income	**(293)**	(368)	(356)
Other income	**(199)**	362	201
Total income	**(492)**	(6)	(155)
Operating expenses	**(30)**	(6)	77
Trading surplus	**(522)**	(12)	(78)
Impairment	**(30)**		(9)
Loss before tax	**(552)**	(12)	(87)

No volatility arises within Central group items and so these results are both statutory and excluding volatility.

restated, see page 28.

Central group items are comprised of three main elements:

1 The funding cost of acquisitions less earnings on capital:

interest costs on central balances, which principally arise from the cost of centrally funded acquisitions net of the proceeds of any subsequent disposals, together with the funding cost of dividend flows;

net interest margin cost resulting from central capital activities, primarily arising on the management of senior and subordinated debt and preference shares net of such cost allocated to the divisions; and

earnings allocated to the UK banking businesses on equity required to support their current activities offset by the income on actual equity held in those businesses.

2 The charge for payments to the Lloyds TSB Foundations: The four independent Lloyds TSB Foundations support registered charities throughout the UK that enable people, particularly the disabled and disadvantaged, to play a fuller role in society. The Foundations receive 1 per cent of the Group s pre-tax profit after adjusting for gains and losses on the disposal of businesses and pre-tax minority interests, averaged over three years, instead of a dividend on their shareholdings.

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

2008 COMPARED TO 2007

Loss before tax from Central group items was £552 million in 2008 compared to £12 million in 2007. Total income was a deficit of £492 million compared to a deficit of £6 million in 2007; income in 2008 has been significantly affected by the impact of yield curve volatility on the fair value of derivatives entered into for risk management purposes, after taking into account the effect of hedge accounting adjustments. Operating expenses were £30 million, compared to £6 million in 2007, reflecting increased central costs that were not recharged to the divisions in connection with professional advice received during 2008; the charge for payments to the Lloyds TSB Foundations was £27 million compared to £37 million in 2007. An impairment charge of £30 million, compared to £nil in 2007, reflected the write-off of the Group s investment in Bradford & Bingley equity shares.

2007 COMPARED TO 2006

Loss before tax from Central group items was £12 million in 2007 compared to £87 million in 2006. Total income was a deficit of £6 million compared to a deficit of £155 million in 2006. Operating expenses were £6 million compared to a credit of £77 million in 2006, as a result of the non-repetition of the pension schemes related credit of £128 million which arose in 2006; following changes in age discrimination legislation in the United Kingdom that year, the Group ceased to augment the pension entitlement of employees taking early retirement, leading to a credit to the income statement. The charge for payments to the Lloyds TSB Foundations was £37 million in both 2007 and 2006.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

VOLATILITY

	2008 **£m**	2007 £m	2006 £m
Insurance volatility	**(746)**	(267)	84
Policyholder interests volatility	**(471)**	(233)	326
Total volatility	**(1,217)**	(500)	410

All volatility is included within Insurance and Investments on a statutory basis.

In addition to presenting the Group s results prepared in accordance with applicable accounting standards, all monthly financial reporting to the group executive committee and board separately presents the results of the businesses before volatility. It is one of the key measures used to evaluate the performance of each of the businesses and forms part of the basis upon which annual incentive scheme awards are made to management.

Management believes that the use of profit before tax excluding volatility provides an additional measure of 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 profit before tax excluding volatility are:

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

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

Management compensates for the limitations above by:

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

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

INSURANCE VOLATILITY

The Group s insurance 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 both the value of the liabilities and investments be reflected within the income statement. As these investments are substantial and movements in their fair value can have a significant impact on the profitability of the Insurance and Investments division, management believes that it is appropriate to disclose the division s results on the basis of an expected return in addition to the actual return. The difference between the actual return on these investments and 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 products written in the Scottish Widows With Profit Fund, the value of the in-force business and the value of shareholders funds. Fluctuations in these values caused by changes in market variables, including market spreads reflecting credit risk premia, are also included within insurance volatility. These market credit spreads represent the gap between the yield on corporate bonds and the yield on government bonds, and reflect the market s assessment of credit risk. Changes in the credit spreads affect the value of the in-force business asset in respect of the annuity portfolio.

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

	2009	2008	2007	2006
	%	%	%	%
Gilt yield (gross)	**3.74**	4.55	4.62	4.12
Equity return (gross)	**6.74**	7.55	7.62	6.72
Dividend yield	**3.00**	3.00	3.00	3.00
Property return (gross)	**6.74**	7.55	7.62	6.72
Corporate bonds in unit-linked and with-profits funds (gross)	**4.34**	5.15	5.22	4.72
Fixed interest instruments backing annuity liabilities (gross)	**5.87**	5.56	5.09	4.65

During 2008, profit before tax included negative insurance volatility of £746 million, being a credit of £9 million to net interest income and a charge of £755 million to other income. During 2007, profit before tax included negative volatility of £267 million, being a credit of £7 million to net interest income and a charge of £274 million to other income. During 2006, profit before tax included positive volatility of £84 million, being a credit of £2 million to net interest income and a credit of £82 million to other income. The charge in 2008 mainly reflects the significant falls in global equity markets during the year, which resulted in total returns some 33 percentage points lower than the expected investment returns set out above. These lower than expected returns reduced the value of in-force business asset in respect of life insurance and participating investment contracts held on the balance sheet. The impact of the widening corporate bond credit spreads more than offset the inclusion of an allowance for the illiquidity premium, and resulted in a net reduction in the value of the annuity portfolio. Lower equity and bond prices also affected the valuation of the Group s investment held within the funds attributable to the shareholders. During 2007, the effect of widening credit risk spreads and falling gilt values more than offset the favourable impact of a modest increase in equity values and changes in market consistent assumptions.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 and pensions business. In order to provide a clearer representation of the performance of the business and consistent with the way in which it is managed, equalisation adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders.

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. Other sources of volatility include the minorities share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.

During 2008, profit before tax included negative policyholder interests volatility of £471 million, being a charge to other income. During 2007, profit before tax included negative volatility of £233 million, being a charge to other income. During 2006, profit before tax included positive volatility of £326 million, being a charge of £33 million to net interest income and a credit of £359 million to other income. In both 2007 and 2008, substantial policyholder tax losses have been generated as a result of a fall in property, bond and equity values. These losses reduce future policyholder tax liabilities and have led to a policyholder tax credit in both years.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2008 Average balance £m	**2008 Interest income £m**	**2008 Yield %**	2007 Average balance £m	2007 Interest income £m	2007 Yield %	2006 Average balance £m	2006 Interest income £m	2006 Yield %
Assets									
Loans and advances to banks	**40,223**	**1,861**	**4.63**	39,381	2,025	5.14	38,696	1,826	4.72
Loans and advances to customers	**219,420**	**13,855**	**6.31**	191,802	13,209	6.89	174,870	10,853	6.21
Available-for-sale financial assets	**25,058**	**1,147**	**4.58**	21,473	1,038	4.83	18,380	807	4.39
Lease and hire purchase receivables	**9,266**	**706**	**7.62**	9,488	602	6.34	10,425	622	5.97
Total interest-earning assets of banking book	**293,967**	**17,569**	**5.98**	262,144	16,874	6.44	242,371	14,108	5.82
Total interest-earning trading securities and other financial assets at fair value through profit or loss	**24,292**	**1,577**	**6.49**	28,524	1,542	5.41	27,584	1,831	6.64
Total interest-earning assets	**318,259**	**19,146**	**6.02**	290,668	18,416	6.34	269,955	15,939	5.90
Allowance for impairment losses on loans and advances	**(2,838)**			(2,268)			(2,171)		
Non-interest earning assets	**60,939**			66,202			63,646		
Total average assets and interest income	**376,360**	**19,146**	**5.09**	354,602	18,416	5.19	331,430	15,939	4.81

	2008 Average interest earning assets £m	**2008 Net interest income £m**	**2008 Net interest margin %**	2007 Average interest earning assets £m	2007 Net interest income £m	2007 Net interest margin %	2006 Average interest earning assets £m	2006 Net interest income £m	2006 Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	**293,967**	**7,718**	**2.63**	262,144	6,099	2.33	242,371	5,329	2.20
Trading securities and other financial assets at fair value through profit or loss	**24,292**	**1,151**	**4.74**	28,524	1,179	4.13	27,584	1,551	5.62
	318,259	**8,869**	**2.79**	290,668	7,278	2.50	269,955	6,880	2.55

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2008 Average balance £m	**2008 Interest expense £m**	**2008 Cost %**	2007 Average balance £m	2007 Interest expense £m	2007 Cost %	2006 Average balance £m	2006 Interest expense £m	2006 Cost %
Liabilities and shareholders funds									
Deposits by banks	**42,150**	**1,540**	**3.65**	38,406	1,919	5.00	36,004	1,680	4.67
Liabilities to banks under sale and repurchase agreements	**5,643**	**253**	**4.48**	3,127	153	4.89	3,907	230	5.89
Customer accounts	**151,013**	**4,932**	**3.27**	142,048	5,085	3.58	128,551	3,738	2.91
Liabilities to customers under sale and repurchase agreements	**106**	**3**	**2.83**	95	2	2.11	2,075	30	1.45
Debt securities in issue	**54,359**	**2,227**	**4.10**	52,743	2,680	5.08	42,472	1,983	4.67
Other interest-bearing liabilities	**4,239**			4,551	195	4.28	4,382	424	9.68
Subordinated liabilities	**15,400**	**896**	**5.82**	13,126	741	5.65	12,129	694	5.72
Total interest-bearing liabilities of banking book	**272,910**	**9,851**	**3.61**	254,096	10,775	4.24	229,520	8,779	3.82
Total interest-bearing liabilities of trading book	**11,769**	**426**	**3.62**	9,971	363	3.64	6,349	280	4.41
Total interest-bearing liabilities	**284,679**	**10,277**	**3.61**	264,067	11,138	4.22	235,869	9,059	3.84
Interest-free liabilities									
Non-interest bearing customer accounts	**3,793**			3,899			4,112		
Other interest-free liabilities	**76,584**			74,628			80,516		
Minority interests and shareholders funds	**11,304**			12,008			10,933		
Total average liabilities and interest expense	**376,360**	**10,277**	**2.73**	354,602	11,138	3.14	331,430	9,059	2.73

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

Average balances are based on daily averages for the principal areas of the Lloyds Banking Group s banking activities with monthly or less frequent averages used elsewhere. Management believes that the interest rate trends are substantially the same as they would be if all balances were averaged on the same basis.

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 2008 compared with 2007 and for 2007 compared with 2006. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2008 compared with 2007 Increase/(decrease)			2007 compared with 2006 Increase/(decrease)		
	Total change £m	**Volume £m**	**Rate £m**	Total change £m	Volume £m	Rate £m
Interest receivable and similar income						
Loans and advances to banks	**(164)**	**39**	**(203)**	199	35	164
Loans and advances to customers	**646**	**1,744**	**(1,098)**	2,356	1,166	1,190
Available-for-sale financial assets	**109**	**164**	**(55)**	231	150	81
Lease and hire purchase receivables	**104**	**(17)**	**121**	(20)	(59)	39
Total banking book interest receivable and similar income	**695**	**1,930**	**(1,235)**	2,766	1,292	1,474
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	**35**	**(275)**	**310**	(289)	51	(340)
Total interest receivable and similar income	**730**	**1,655**	**(925)**	2,477	1,343	1,134
Interest payable						
Deposits by banks	**(379)**	**137**	**(516)**	239	120	119
Liabilities to banks under sale and repurchase agreements	**100**	**113**	**(13)**	(77)	(38)	(39)
Customer accounts	**(153)**	**293**	**(446)**	1,347	483	864
Liabilities to customers under sale and repurchase agreements	**1**		**1**	(28)	(42)	14
Debt securities in issue	**(453)**	**66**	**(519)**	697	522	175
Other interest bearing liabilities	**(195)**		**(195)**	(229)	7	(236)
Subordinated liabilities	**155**	**132**	**23**	47	56	(9)
Total banking book interest payable	**(924)**	**741**	**(1,665)**	1,996	1,108	888
Total interest payable on trading and other liabilities at fair value through profit or loss	**63**	**65**	**(2)**	83	132	(49)
Total interest payable	**(861)**	**806**	**(1,667)**	2,079	1,240	839

RISK MANAGEMENT

THE GROUP S APPROACH TO RISK

The Group s approach to risk is founded on strong corporate governance practices whereby the board takes the lead in 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 prohibit and, where appropriate, limit activities, relationships, and situations, that might diminish the quality of corporate governance. All colleagues from the group chief executive down are assessed against a balanced scorecard that explicitly addresses their risk 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 put in place. 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. Within the Group there is a strong culture of command and control from the centre with short lines of communication between divisions and functions.

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 their respective monthly meetings. This is a key component of the Group s approach to risk management and provides oversight on behalf of the board to line management in specific business areas and activities. It is supported by the chief risk officer being a full member of the group executive committee and reporting to the group chief executive with direct access to the chairman and the risk oversight committee.

Table 1.1 sets out the role of the second line of defence and in particular that of the risk oversight committee and its interaction with the chief risk officer, the group risk directors and the divisional risk officers. This structure which has been in place for a number of years, has evolved with the risk oversight committee reviewing regular reports on the Group s risk exposures as well as taking a keen interest in the adequacy and capability of resources within the risk functions.

The Group has historically adopted a conservative business model and risk culture. The focus has been and remains on building and maintaining long-term relationships with customers. This involves taking a through the cycle view whereby the sustainability of a relationship through good and bad economic times is taken into account. The approach is supported by a through the cycle approach to risk with strong central control and monitoring.

There is a matrix approach to risk management which includes group risk directors being responsible for individual risk types in aggregate across the Group and divisional risk officers being responsible for the aggregate risk profile within their respective divisions. The group risk directors and divisional risk officers all have a direct reporting line to the chief risk officer. This matrix approach enables the group executive committee members to fulfil their accountabilities for risk management and enables the chief risk officer to inform the risk oversight committee of the aggregate risk profile of the Group.

On 16 January 2009 Lloyds TSB Group plc acquired 100 per cent of the ordinary share capital of HBOS plc and changed its name to Lloyds Banking Group plc. Accordingly, where this section provides information for dates prior to 16 January 2009, such information relates to the Lloyds Banking Group prior to the acquisition of HBOS plc.

The paragraphs that follow set out the risk management policies, practices and structures that applied during 2008 to the heritage Lloyds TSB Group. These policies, practices and structures were adopted by Lloyds Banking Group from the date of completion of the HBOS plc transaction and do not describe those applied by HBOS plc prior to its acquisition.

RISK AS A STRATEGIC DIFFERENTIATOR

The Group seeks to optimise performance by allowing divisions and business units to operate within capital and risk parameters and the Group s policy framework. They must do so in a way which is consistent with realising the Group s strategy and meeting agreed business performance targets. The Group s approach to risk management seeks to ensure the business remains accountable for risk whilst also ensuring there is effective independent oversight.

The Group has continued to focus on enhancing its capabilities in providing both qualitative and quantitative data to the board on risks associated with strategic objectives and facilitating more informed and effective decision making. The Group s ability to take risks which are well understood and consistent with its strategy and plans is a key driver of shareholder return.

The maintenance of a strong control framework remains a priority and is the foundation for the delivery of effective risk management. Risk analysis and reporting capabilities support the identification of opportunities as well as risks and provide an aggregate view of the overall risk portfolio. Risk mitigation strategies clearly aligned with responsibilities and timescales are monitored at group and divisional level. Risk continues to be a key component of routine management information reporting.

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 colleague performance is judged. Business executives have specified risk management objectives, and incentive schemes take account of performance against these.

MARKET DISLOCATION

During 2008, the global dislocation in financial markets resulted in exceptional instability and volatility impacting upon market and investor confidence which has been characterised by a marked reduction in liquidity. This crisis in the financial markets led the UK Government to inject liquidity into the financial system and to require (and participate in) recapitalisation of the banking sector to restore confidence to the market.

During October 2008, as part of the co-ordinated package of capital and funding measures for the UK banking sector, implemented by HM Treasury, the Group participated in the UK Government Funding Package and thereby facilitated access to the UK Government backed provision of liquidity. For further details on the UK Government Funding Package see Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government .

There can be no assurance that the measures so far announced by the UK Government will be sufficient to prevent any future strain on the Group s ability to meet its financial obligations as they fall due. The recovery of wholesale and capital markets will depend upon renewed confidence in the UK banking system, particularly if market conditions revert to the reduced levels of wholesale market liquidity and the availability of traditional sources of funding become more limited.

The key dependencies on successfully funding the Group s balance sheet include the continued functioning of the money and capital markets at their current levels; the continued access of the Group to central bank and UK Government sponsored liquidity facilities, including issuance under HM Treasury s credit guarantee scheme (CGS) and access to the Bank of England s various facilities; limited further deterioration in the Group s credit ratings; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or UK Government support schemes.

Based upon projections by management, which take into account the acquisition on 16 January 2009 of HBOS plc, and assume the availability of the existing and announced Government Funding Package, the Group believes it has adequate resources to continue in business for the foreseeable future.

RESPONSES TO MARKET DISLOCATION AND BANKING CRISIS

During the market dislocation there has been even more rigorous focus on the governance, accountabilities and execution capabilities to ensure adherence to an even lower risk profile. It was already part of the Group s approach to learn from adverse situations regardless of whether there has been any direct business impact. Accordingly, lessons learned exercises form part of normal activity and have been carried out during this turbulent period. The Group s risk culture has manifested itself in some clear and critical pre-crunch wholesale and capital markets policy actions that served to limit exposure.

As the Group has developed its credit, liquidity and market risk control frameworks, particular focus has been placed on the control of credit spread risk, associated stress testing and modelling. During 2008, the Group has further strengthened its oversight of liquidity, funding, capital and asset liability management issues with the upgrading of membership of the group asset and liability committee. Membership consists of group executive committee members and the treasurer, and it is chaired by the chief executive. A senior asset and liability committee has been created to support the group asset and liability committee. There have also been a number of further developments to the Group s liquidity control frameworks that have been instituted including further developments of stress testing. During the height of the crisis, daily meetings with the group chief executive were held to assess the Group s position which has held up well during the worst aspects of the market dislocation.

In respect of credit risk, the Group has reduced exposure via exit or scaling back of positions. In wholesale and capital market exposure, the Group has restricted investment policy for its conduit Cancara ; restricted exposure to monolines and leveraged loans; reviewed liquidity risk appetite and enhanced liquidity reporting; reduced holdings of equities in the insurance companies; progressed its pension scheme de-risking strategy and tightened policy parameters for US sub-prime mortgages. Also, all exposures were sanctioned on the basis of the Group being content to hold the risk to maturity. In retail banking, risk mitigation activities and a prudent lending stance were maintained in the context of the changing environment: tightening of maximum loan to value criteria on all mortgage books; withdrawal of higher risk mortgage products; tightening of credit card eligibility criteria and tightening of policy rules and scorecard cut offs across all retail portfolios.

Consistent with its through the cycle approach, the Group has a proactive and supportive approach to assist customers through difficult periods. The Group has also invested significantly in its highly successful collections and recoveries and business support units.

RISK GOVERNANCE STRUCTURES

The Group maintains a risk governance structure that 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. This structure has been tried and tested by the heritage Lloyds TSB Group and will remain the same for Lloyds Banking Group. The risk governance structure for the Lloyds Banking Group is shown in table 1.1.

BOARD AND COMMITTEES

The board, assisted by its committees, the risk oversight committee, the group executive committee, and the group 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 seek to ensure that these are consistent with the board s appetite for risk. The role of the board, audit committee and risk oversight committee are shown in the corporate governance section on pages 101 and 102, and further key risk oversight roles are described below.

There is strong cross membership of non-executive directors between remuneration, audit and risk oversight committees.

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 executive committee s duties are described in greater detail on pages 101 and 102. The group executive committee members are also members of the group business risk committee and the group asset and liability committee, both of which are chaired by the group chief executive. The group business risk committee is supported by the following:

The **group compliance and operational risk committee** is responsible for proactively identifying current and emerging significant compliance 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** 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 committeee, 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** 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 change management committee** is responsible for ensuring that the aggregate risks associated with the Group s project portfolio are identified, assessed and mitigated, thereby ensuring that the portfolio remains deliverable within an acceptable level of risk.

The **group asset and liability committee** is supported by the **senior asset and liability committee,** which is responsible for the review and escalation of issues of group level significance to the group asset and liability committee relating to 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.

Supporting the chief risk officer, the risk forum consists of the divisional risk officers and the group risk directors. The risk forum regularly reviews a summary of risks across the risk management spectrum to determine areas of focus for remedial action across the Group.

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 oversight committee, the group business risk committee, the group asset and liability committee, group risk and the divisional risk officers.

Table 1.1: RISK GOVERNANCE STRUCTURES

The risk management policies, practices and structures that applied during 2008 to the heritage Lloyds TSB Group were adopted by Lloyds Banking Group from the date of completion of the HBOS transaction and are now being implemented for the heritage HBOS business.

RISK MANAGEMENT OVERSIGHT

The chief risk officer, a member of the group executive committee and reporting directly to the group chief executive, oversees and promotes the development and implementation of a consistent group-wide risk management framework. The chief risk officer, supported by the group risk department and the divisional risk officers, provides objective challenge to the Group s senior management. The chief risk officer also reports independently to the risk oversight committee (see page 102) that comprises non-executive directors and is chaired by the Group chairman.

Group risk directors are allocated responsibility for specific risk types and are responsible for ensuring the adequacy of risk resources as well as the oversight of the risk profile across the Group.

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 the chief risk officer, their day-to-day contact with business management, business operations and risk initiatives seeks to provide an effective risk oversight mechanism.

The director of group audit provides the required 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.

BUSINESS RISK MANAGEMENT

Line management is directly accountable for the management of risks arising from the Group s business. A key objective is to ensure that business decisions strike an appropriate balance between risk and reward, consistent with the Group s risk appetite. The senior executive team 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.

All business units, divisions and group functions complete a control self-assessment annually (described on page 103), reviewing the effectiveness of their internal controls and putting in place enhancements where appropriate. Managing directors and group executive directors certify the accuracy of their assessment.

Business risk management forms part of a tiered risk management model, as shown in table 1.1, 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

The Group s risk management principles and risk management framework cover the full spectrum of risks that a group, that 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, designed to meet its customers needs. 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, where appropriate; and exploit risks to gain competitive advantage, thereby seeking to increase shareholder value. The principal elements of the risk management framework are shown in table 1.2.

The risk management framework below comprises 10 interdependent activities which map to the components of the internal control-integrated framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO).

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.

Table 1.2: RISK MANAGEMENT FRAMEWORK

The Lloyds Banking Group business strategy is used to determine the Group s high level risk principles and risk appetite measures and metrics for the primary risk drivers (see table 1.3). A key focus has been to develop earnings volatility measures to complement existing capital measures for risk appetite. The risk appetite is proposed by the group chief executive and reviewed by various governance bodies including the group executive committee and the risk oversight 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 directors 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 following policy levels:

Principles high level principles for the six primary risk drivers

High level Group policy policy for the main risk types aligned to the risk drivers

Detailed Group policy detailed policy that applies across the Group

Divisional policy local policy that specifically applies to a division

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

Divisional and business unit policy is only produced by exception and is not necessary unless there is a specific area for which a particular division or business unit requires a greater level of detail than is appropriate for group level policy. The governance arrangements for development of, and compliance with, group, divisional and business unit policy and the associated accountabilities are clearly outlined. All staff are expected to be aware of the 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 staff within that area.

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.

Proportionate **control activity** strategy is in place to design mitigating controls, to transfer risk where appropriate and 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 and stress testing.

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 when reporting, 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 divisional executive committees to ensure that respective senior management is satisfied with the overall risk profile, risk accountabilities and progress on any necessary **mitigating actions**. 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. Any significant issues identified in the **monitoring** process are appropriately reported, and an escalation process is in place to report significant losses to appropriate levels of management. Group risk reports on risk exposures and material issues quarterly to the group asset and liability committee, group business risk committee, group executive committee, risk oversight 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 oversight committee and the board to ensure senior management and the board are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The consolidated risk report provides a regular 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 12 months.

RISK DRIVERS

The Group s risk language is designed to capture the Group s principal risks referred to as the primary risk drivers . A description of each risk, including definition, appetite, control and exposures, is included below. These are further broken down into 28 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out in table 1.3.

Through the Group s risk management processes these risks are assessed on an ongoing basis 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.

Table 1.3: RISK DRIVERS

PRINCIPAL RISKS

At present the most significant risks faced by the Group are:

People risk: the Group s recent improvement to its people risk exposure, driven by leadership development and succession planning strategies, is now challenged by the HBOS integration and market disruption. External pressure on incentivisation in the banking industry increases the risk of losing specialist resources. The Group is responding to these pressures and taking steps to retain resources.

Credit risk: arising in the UK Retail and Wholesale and International Banking divisions and the Treasury function reflecting the risks inherent in the Group s lending activities. During 2008, the banking crisis has impacted the financial services industry resulting in high profile losses and write-downs. The deteriorating economic outlook, both in the UK and overseas, is also leading to significant rises in impairments. The Group is impacted by the economic downturn and a further worsening of the business environment could adversely impact earnings. This poses a major risk to the Group and its lending businesses in:

Retail, where rising unemployment impacts the ability of customers to meet repayment dates on unsecured and secured lending and leads to a consequent increase in arrears. Additionally, the downturn in the housing market reduces collateral values for residential property and this impacts upon the profitability of secured lending.

Wholesale, where companies are facing increasingly difficult conditions, resulting in corporate default levels rising and leading to increases in corporate impairment.

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

Liquidity and funding: arising in the banking business of the Group and impacting the UK Retail and Wholesale and International Banking divisions reflecting the risk that the Group is unable to attract and retain retail/wholesale 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, it could impact its ability to fund its financial obligations. Throughout the market dislocation, the Group has maintained a liquidity position based on its significant retail and corporate deposit base and has continued to obtain funding in the wholesale markets. Since completion of the HBOS transaction, the Group has been able to fund the enlarged Group in the wholesale markets at rates comparable to the period prior to completion. In addition the Group has reinforced its funding position by actively participating in the support initiatives introduced by the Bank of England and HM Treasury. Prior to the year end 2008 additional liquidity was built up to mitigate the potential for hightened liquidity risk faced by Lloyds Banking Group plc upon the acquisition of HBOS plc. The recent downgrade by rating agencies has not had a material impact on the cost of short-term wholesale funding.

Capital: during 2008, there was unprecedented turbulence in global financial markets which led to the UK Government taking action to stabilise the UK banking system. After discussion with HM Treasury on the additional capital required by the UK Government if the Group were to continue to have access to the Government backed provision of liquidity, the board decided it was in the best interests of shareholders for the Group to participate in the industry wide recapitalisation exercise which took place in October 2008. However, should the economic downturn worsen and consequently the Group sustain further sudden and significant shocks to its capital base, it could be necessary to raise additional capital to remain above the FSA s minimum target ratios. Any additional capital raised which was not taken up by existing shareholders would be dilutive to their earnings.

Market risk: In terms of potential impact on economic value, the principal market risks are a fall in equity markets reducing the value of assets in the Group s pension schemes and in the Insurance and Investments division, and exposure to a fall in real interest rates increasing the value of liabilities in the Group s pension schemes. In terms of potential impact on earnings, the principal market risks are exposure to a fall in equity markets reducing the value of assets in the Insurance and Investments division, and exposure to a widening of credit spreads reducing the value of assets in the Insurance and Investment division and in the trading book. Also, in the retail banking businesses, there is a potential impact on earnings arising from margin compression in a lower UK base rate environment. All risks are subject to regular review and mitigation activity via specific initiatives monitored by the group and senior asset and liability committees, including engagement with the pension scheme trustees.

Insurance risk: arising in Insurance and Investments division and the Group s pension schemes reflecting the exposure to increasing longevity of annuitants and pensioners. The main mitigation option open to the Group is to hedge the risk in the reinsurance or the capital markets and the Group actively monitors the attractiveness of potential opportunities in these markets.

Legal and regulatory risk: arising in all divisions and reflecting the legal and regulatory environment in which the Group operates and the volume and pace of change from within the UK and the rest of the world. This impacts the Group, both operationally in terms of cost of compliance with uncertainty about legal and regulatory expectations, and strategically through pressure on key earnings streams. The latter could potentially result in changes to business and pricing models, particularly in the UK retail and smaller business markets. The Group s business planning processes continue to reflect change to the legal and regulatory environment. Major current legal and regulatory reviews and proceedings are described on pages 108 to 114. In addition, the Group faces risk where legal or regulatory proceedings are brought against it. Regardless of whether such claims have merit, the outcome of such proceedings is inherently uncertain and could result in financial loss.

Integration risk

A further risk arises as a result of the acquisition of HBOS plc by Lloyds TSB Group plc reflecting the risk that the Group may fail to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or may incur unanticipated costs and losses associated with, the acquisition of HBOS plc. As a consequence the Group results may suffer as a result of operational, financial, management and other integration risks. The Group has created an integration committee as a sub-committee to the group executive committee to oversee the integration process.

IMPACT OF HERITAGE LLOYDS TSB GROUP RISK MANAGEMENT PRACTICES ON HBOS

Following completion of the acquisition of HBOS plc, Lloyds Banking Group has moved swiftly to apply its risk management practices to the HBOS Group. As part of the completion process, the heritage Lloyds TSB Group high level policies have been amended so that they could be introduced for Lloyds Banking Group (including HBOS plc and its subsidiaries).

On the completion date, the heritage Lloyds TSB Group governance structure became the applicable governance structure for Lloyds Banking Group (including HBOS plc and its subsidiaries). This represented a change to the committee structures and delegated authorities for the heritage HBOS businesses. The major areas of change included material event escalation, sanctions, conflicts of interest, delegated authorities for expenditure and the credit sanctioning process where authorities were changed to align with those within the heritage Lloyds TSB Group businesses.

The way the Group manages risk is central to its success. The board takes its responsibility for risk management very seriously and all of the Group s senior executives are actively involved in overseeing the risk profile for Lloyds Banking Group.

BUSINESS RISK

DEFINITION

Business risk is defined as the risk to economic profit in the Group s budget and over the medium-term plan arising from a sub optimal business strategy or the sub-optimal implementation of the plan as agreed by the board. 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 subsequently align their plans 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.

MEASUREMENT

An annual business planning process is conducted at group 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. Over the last few years, the Group has made significant progress with embedding stress testing and scenario analysis into its risk management practice with the dual objectives of adding value to the business whilst also meeting regulatory requirements. The Group assesses a wide array of scenarios including economic recessions, regulatory action scenarios, pandemics and scenarios specific to the operations of each part of the business.

A common approach is applied across the Group to assess the creation of shareholder value. This is measured by economic profit (the profit attributable to shareholders, less a notional charge for the equity invested in the business). The focus on economic profit allows the Group to compare the returns being made on capital employed in each business on a consistent basis.

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. 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

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

Credit risk appetite is expressed both in terms of credit risk economic equity and in terms of the impact of credit risk on earnings volatility.

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 model parameters which in turn use the various credit risk rating systems as inputs. These metrics are supplemented by a variety of policies, sector caps and limits to manage concentration risk at an acceptable level.

EXPOSURES

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 49 to the consolidated financial statements.

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, derivatives and foreign exchange activities. Note 17 to the consolidated financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December

2008. 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 49 to the consolidated financial statements.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers.

MEASUREMENT

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the probability of default by the client or 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 assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. For its retail lending, and a growing number of wholesale lending portfolios, exposure at default and loss given default models are also in use. All material rating models are authorised by executive management. 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 rigorous validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible.

Each probability of default rating model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between classifications if the assessment of the obligor 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 49 to the consolidated financial statements provides an analysis of the portfolio.)

The rating systems described above assess probability of default, exposure at default and loss given default, in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment (see note 20 to the consolidated 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 model that is used for internal operational management and banking regulation purposes.

The Group s Corporate Markets debt securities holdings, which are the subject of external agency ratings, are marked to market and independently checked by the middle office function within the products and markets business. Similarly, debt security investments within Scottish Widows are independently marked to market.

The Group also employs a statistically-based credit portfolio model, which models portfolio credit risk based on defaults and calculates the economic equity employed and credit value at risk for each portfolio.

MITIGATION

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

INTERNAL CONTROL

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 policy are reviewed regularly and any changes are subject to a review and approval process. Divisional and business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. Credit policy also specifies maximum holding period limits for the credit trading portfolios.

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 considered and limit breaches are subject to escalation procedures.

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.

Credit scoring: In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Divisional risk departments review scorecard effectiveness and approve changes, with material changes to scorecards that form part of a probability of default rating system subject to group risk approval.

Controls over rating systems: The Group has established a robust and independent process built on a set of common minimum standards designed to challenge the discriminatory power of the systems, accuracy of calibration and ability to rate consistently over time and across obligors. The internal rating systems are developed and implemented by independent risk functions either in the business units or divisions with the business unit managing directors having ownership of the systems. They also take responsibility for ensuring the validation of the respective internal rating systems, supported and challenged by specialist functions in their respective division.

Cross-border and cross-currency exposures: Country limits are authorised by a Country Limits Panel and managed by a dedicated unit taking into account economic and political factors.

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 and more vulnerable sectors. Note 19 to the consolidated financial statements provides an analysis of loans and advances to customers by industry (for wholesale) and product (for retail). Exposures are monitored to prevent 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.

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, for a specific industry sector.

Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control; 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. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.

COLLATERAL

The principal collateral types for loans and advances are:

- mortgages over residential properties;
- charges over business assets such as premises, inventory and accounts receivable;
- 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

Portfolio monitoring and reporting: 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 business risk committee.

The performance of all rating models is comprehensively monitored on a regular basis, to ensure that models continue to provide optimum risk differentiation capability, the generated ratings remain as accurate and robust as possible 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LOAN PORTFOLIO

ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

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

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Loans and advances to banks	**40,916**	34,845	40,639	31,656	31,849
Loans and advances to customers:					
Mortgages	**114,643**	102,739	95,601	88,895	80,342
Other personal lending	**25,318**	22,988	23,025	23,280	23,190
Agriculture, forestry and fishing	**3,969**	3,226	2,905	2,451	2,107
Energy and water supply	**2,598**	2,102	2,024	1,592	953
Manufacturing	**12,057**	8,385	7,513	7,923	4,491
Construction	**3,016**	2,871	2,332	2,222	1,990
Transport, distribution and hotels	**14,664**	11,573	10,490	9,465	8,710
Postal and telecommunications	**1,060**	946	831	546	346
Financial, business and other services	**35,746**	29,707	22,999	21,261	17,739
Property companies	**23,318**	17,576	12,896	8,713	6,078
Lease financing	**4,620**	4,686	4,802	5,815	6,227
Hire purchase	**5,295**	5,423	5,060	4,853	4,828
Total loans	**287,220**	247,067	231,117	208,672	188,850
Allowance for impairment losses	**(3,727)**	(2,408)	(2,194)	(2,073)	(1,663)
Interest held in suspense					(21)
Total loans and advances net of allowance for impairment losses	**283,493**	244,659	228,923	206,599	187,166

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

SUMMARY OF LOAN LOSS EXPERIENCE

The following tables analyse the movements in the allowance for impairment losses for each of the five years listed.

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Balance at beginning of year before transition to IAS 39				1,663	1,695
Adjustment to reflect transition to IAS 39 on 1 January 2005				256	
Balance at beginning of year after transition to IAS 39	**2,408**	2,194	2,073	1,919	
Exchange and other adjustments	**43**	2	(13)	1	(11)
Reclassifications				43	
Acquisition and disposal of businesses and portfolios			(27)	(27)	(33)
Advances written off:					
Loans and advances to customers:					
Mortgages	**(23)**	(25)	(9)	(6)	(2)
Other personal lending	**(1,206)**	(1,256)	(1,195)	(904)	(760)
Agriculture, forestry and fishing	**(2)**	(1)	(1)	(1)	(11)
Energy and water supply	**(24)**	(11)	(17)	(20)	(18)
Manufacturing	**(34)**	(13)	(24)	(27)	(57)
Construction	**(11)**	(4)	(7)	(8)	(3)
Transport, distribution and hotels	**(50)**	(24)	(50)	(37)	(34)
Financial, business and other services	**(193)**	(95)	(142)	(151)	(61)
Property companies	**(6)**		(4)		(15)
Lease financing	**(2)**	(26)	(1)	(5)	(3)
Hire purchase	**(59)**	(87)	(39)	(77)	(49)
Loans and advances to banks					(15)
Total advances written off	**(1,610)**	(1,542)	(1,489)	(1,236)	(1,028)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	**1**	2	2	2	2
Other personal lending	**102**	121	158	125	119
Agriculture, forestry and fishing					3
Energy and water supply			1	2	
Manufacturing		1	3	4	8
Construction			1	1	7
Transport, distribution and hotels	**1**	1	4	5	14
Financial, business and other services	**3**	3	12	14	15
Hire purchase	**5**	9	9	5	6
Total recoveries of advances written off	**112**	137	190	158	174
Total net advances written off	**(1,498)**	(1,405)	(1,299)	(1,078)	(854)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Effect of unwinding of discount recognised through interest income	**(102)**	(104)	(100)	(87)	
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	**171**	18	12	18	4
Other personal lending	**1,455**	1,313	1,349	1,192	805
Agriculture, forestry and fishing	**2**	4	1		(2)
Energy and water supply	**35**	18	4	2	40
Manufacturing	**122**	19	12	(1)	4
Construction	**61**	8	5	(3)	4
Transport, distribution and hotels	**66**	39	29	20	43
Financial, business and other services	**625**	151	53	7	(24)
Property companies	**73**	1			15
Lease financing	**1**	35	4	(3)	7
Hire purchase	**107**	116	91	70	57
General provisions					(87)
Loans and advances to banks	**158**	(1)			
Total allowances for impairment losses charged against income for the year	**2,876**	1,721	1,560	1,302	866
Total balance at end of year	**3,727**	2,408	2,194	2,073	1,663
Ratio of net write-offs during the year to average loans outstanding during the year	**0.6%**	0.7%	0.7%	0.6%	0.6%

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

	2008 Allowance £m	**2008 Percentage of loans in each category to total loans %**	2007 Allowance £m	2007 Percentage of loans in each category to total loans %	2006 Allowance £m	2006 Percentage of loans in each category to total loans %	2005 Allowance £m	2005 Percentage of loans in each category to total loans %	2004 Allowance £m	2004 Percentage of loans in each category to total loans %
Balance at year end applicable to:										
Loans and advances to banks	**158**	**14.2**		14.1	1	17.6	1	15.2	1	16.9
Loans and advances to customers:										
Mortgages	**186**	**40.0**	37	41.5	42	41.3	36	42.5	11	42.4
Other personal lending	**2,047**	**8.8**	1,795	9.3	1,720	9.9	1,533	11.2	795	12.3
Agriculture, forestry and fishing	**5**	**1.4**	5	1.3	2	1.3	2	1.2	4	1.1
Energy and water supply	**33**	**0.9**	22	0.9	14	0.9	32	0.8	63	0.5
Manufacturing	**119**	**4.2**	29	3.4	25	3.3	33	3.8	95	2.4
Construction	**60**	**1.1**	10	1.2	6	1.0	8	1.1	17	1.1
Transport, distribution and hotels	**75**	**5.1**	58	4.7	45	4.5	64	4.5	90	4.6

Postal and telecommunications		**0.4**		0.4		0.4		0.3		0.2
Financial, business and other services	**706**	**12.4**	232	12.0	166	9.9	250	10.1	206	9.4
Property companies	**70**	**8.1**	4	7.1	5	5.6	11	4.2		3.2
Lease financing	**15**	**1.6**	16	1.9	7	2.1	4	2.8	10	3.3
Hire purchase	**253**	**1.8**	200	2.2	161	2.2	99	2.3	91	2.6
Total before general provision	**3,727**	**100.0**	2,408	100.0	2,194	100.0	2,073	100.0	1,383	100.0
General provision									280	
Total balance at year end	**3,727**	**100.0**	2,408	100.0	2,194	100.0	2,073	100.0	1,663	100.0

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK ELEMENTS IN THE LOAN PORTFOLIO

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

NON-PERFORMING LENDING

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

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

2004

In accordance with IFRS as applicable in 2004, the Group continued to accrue interest, where appropriate, on doubtful debts when there was a realistic prospect of recovery. This interest was charged to the customer s account but it was not credited to income; it was placed on a suspense account and only taken to income if there ceased to be significant doubt about its being paid.

Loans were transferred to non-accrual status where the operation of the customer s account had ceased. This lending was managed by specialist recovery departments and written down to its estimated realisable value. Interest was not added to the lending or placed on a suspense account as its recovery was considered unlikely; it was only taken to income if it was received.

	2004 £m
Loans accounted for on a non-accrual basis	673
Accruing loans on which interest is being placed in suspense	567
Accruing loans on which interest is still being accrued and taken to profit, and against which specific provisions have been made*	1,365
Loans contractually past due 90 days or more as to principal or interest, but against which no provisions have been made	1,040
Total non-performing lending	3,645

* Included within accruing loans on which interest is still being accrued and taken to profit, and against which specific provisions have been made, in 2004 was £1m in respect of troubled debt restructurings.

2005

In 2005, the Group adopted IAS 39, which requires that interest is accrued and recognised on all outstanding loans. The interest recognised is based on the net carrying value of the loan and is, therefore, less than that that would be recognised on a similar performing loan. Accordingly, it is no longer possible to classify non-performing lending as being accounted for on a non-accruals basis. A provision is established if there is objective evidence that impairment has occurred and the carrying value of the loan exceeds the present value of its estimated future cash flows discounted at the loan s original effective interest rate.

As a result of the changes, the Group analysed its 2005 non-performing lending between impaired loans with a provision and impaired loans contractually past due 90 days or more without a provision.

	2005 £m
Impaired lending against which provisions are held	4,122
Loans contractually past due 90 days or more as to principal or interest, but against which no provisions have been made	1,210
Total non-performing lending*	5,332

* There were no troubled debt restructurings in 2005.

2006, 2007 and 2008

In 2007, the Group adopted IFRS 7, which requires more detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, for 2006, 2007 and 2008, 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss	Loans and advances to banks
	Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	£m	£m
31 December 2008						
Neither past due nor impaired	**110,148**	**33,571**	**89,208**	**232,927**	**608**	**40,741**
Past due but not impaired	**3,134**	**1,146**	**555**	**4,835**		**17**
Impaired no provision required	**479**	**150**	**1,253**	**1,882**		
provision held	**882**	**4,327**	**1,451**	**6,660**		**158**
Gross	**114,643**	**39,194**	**92,467**	**246,304**	**608**	**40,916**
31 December 2007						
Neither past due nor impaired	99,828	29,850	73,475	203,153	1,189	34,845
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	102,739	34,516	74,967	212,222	1,189	34,845
31 December 2006						
Neither past due nor impaired	92,873	29,364	60,005	182,242	835	40,638
Past due but not impaired	1,943	1,005	374	3,322		
Impaired no provision required	658	92	158	908		
provision held	127	3,580	299	4,006		1
Gross	95,601	34,041	60,836	190,478	835	40,639

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.

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				Loans and advances designated at fair value through profit or loss	Loans and advances to banks
	Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	£m	£m
31 December 2008						
0-30 days	**1,527**	**853**	**289**	**2,669**		
30-60 days	**633**	**259**	**90**	**982**		
60-90 days	**424**	**32**	**70**	**526**		**17**
90-180 days	**549**	**2**	**77**	**628**		
Over 180 days	**1**		**29**	**30**		
Total	**3,134**	**1,146**	**555**	**4,835**		**17**

31 December 2007				
0-30 days	1,123	781	266	2,170
30-60 days	445	155	107	707
60-90 days	260	29	129	418
90-180 days	325	1	67	393
Over 180 days			70	70
Total	2,153	966	639	3,758
31 December 2006				
0-30 days	1,104	797	156	2,057
30-60 days	341	182	60	583
60-90 days	216	26	38	280
90-180 days	280		70	350
Over 180 days	2		50	52
Total	1,943	1,005	374	3,322

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

POTENTIAL PROBLEM LOANS

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

2004 and 2005

There were no similar disclosure requirements in the UK for the years ended 31 December 2004 and 2005.

The following tables disclose for 2004 and 2005 lendings which were current as to payment of interest and principal but where concerns existed about the ability of the borrowers to comply with loan repayment terms in the near future:

	2005 £m	2004 £m
Potential problem lending	1,800	1,450

The figures shown for potential problem lending are not indicative of the losses that might arise should the credit quality of this lending deteriorate since they do not take into account security held.

2006, 2007 and 2008

IFRS 7 requires, for 2006, 2007 and 2008, 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, lower quality and those that are below standard but not impaired.

	Loans and advances to customers				**Loans and advances designated at fair value through profit or loss**	**Loans and advances to banks**
	Retail mortgages £m	**Retail other £m**	**Wholesale £m**	**Total £m**	**£m**	**£m**
31 December 2008						
Good quality	**109,437**	**21,251**	**50,718**		**129**	**40,295**
Satisfactory quality	**643**	**9,305**	**34,559**		**411**	**192**
Lower quality		**900**	**3,444**		**56**	**240**
Below standard, but not impaired	**68**	**2,115**	**487**		**12**	**14**
Total	**110,148**	**33,571**	**89,208**	**232,927**	**608**	**40,741**
31 December 2007						
Good quality	99,407	18,157	46,240		191	34,647
Satisfactory quality	378	8,964	25,013		670	190
Lower quality	1	665	2,034		327	7
Below standard, but not impaired	42	2,064	188		1	1
Total	99,828	29,850	73,475	203,153	1,189	34,845
31 December 2006						
Good quality	92,472	16,940	35,659		513	40,418
Satisfactory quality	359	9,667	21,797		314	201
Lower quality		663	2,249		3	17

Below standard, but not impaired	42	2,094	300		5	2
Total	92,873	29,364	60,005	182,242	835	40,638

For further details see page F-77.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

	2008 £m
Interest income that would have been recognised under original contract terms	**661**
Interest income included in profit	**(435)**
Interest foregone	**226**

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 can be discontinued at the end of the first year.

As noted above, the Group adopted IFRS 7 in 2007; IFRS 7 requires the disclosure of loans that were renegotiated and that would otherwise have been past due or impaired (2008: £144 million; 2007: £579 million; 2006: £342 million); see also page F-78.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 takes control of a property held as collateral on a loan at repossession but title does not transfer to it. 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.

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 tables analyse, 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 institutions £m	Banks and other financial institutions £m	Commercial, industrial and other £m
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 2007:					
Netherlands	1.8	6,245	1	3,806	2,438
United States of America	1.3	4,520	38	1,098	3,384
As at 31 December 2006:					
Belgium	1.5	5,081	3	4,607	471
France	1.3	4,389	40	3,224	1,125
United States of America	1.2	4,255	218	1,478	2,559
Netherlands	1.2	4,018	6	1,595	2,417
Germany	1.1	3,655	12	3,274	369

As at 31 December 2008, France had commitments of £571 million, Netherlands had commitments of £496 million and United States of America had commitments of £476 million.

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.

As at 31 December 2007, the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £8,505 million in total, were Germany, Republic of Ireland and Belgium.

As at 31 December 2006, there was no country with cross border outstandings of between 0.75 per cent and 1 per cent of assets.

MARKET RISK

DEFINITION

The risk of reductions in earnings and/or value, through financial or reputational loss, arising from unexpected changes in financial prices, including interest 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.

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.

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:

- The management of the With Profit Fund within Scottish Widows involves mismatching of assets and liabilities with the aim of generating a higher rate of return on assets to meet policyholders expectations.
- 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.
- 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 three portfolios: the surplus in the non-profit fund within the Long Term Fund of Scottish Widows plc, assets in shareholder funds of life assurance companies and an investment portfolio within the general insurance business.

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 37 to the consolidated financial statements.

MEASUREMENT

The primary market risk measure used within the Group is the Value at Risk (VaR) methodology, which incorporates the volatility of relevant market prices and the correlation of their movements. This is used for determining the Group s overall market risk appetite and for the high level allocation of risk appetite across the Group.

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.

During 2008, the Group introduced group-wide stress testing to measure exposure to credit spread widening across all businesses in response to the market dislocation that has impacted the observable inputs to asset pricing.

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 2008 and 2007 based on the Group s global trading positions was as detailed in table 1.4.

The risk of loss measured by the VaR model is the potential loss in earnings. The total and average trading VaR does not assume any diversification benefit across the four risk types. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. VaR numbers have increased during 2008 due to the significant rise in market volatility reflected in all the Group s VaR models across all markets.

TABLE 1.4: BANKING TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

	31 December 2008			
	Close £m	**Average £m**	**Maximum £m**	**Minimum £m**
Interest rate risk	**6.73**	**3.36**	**14.67**	**0.96**
Foreign exchange risk	**2.95**	**1.22**	**4.06**	**0.08**
Equity risk	**0.00**	**0.25**	**2.67**	**0.00**
Credit spread risk	**7.97**	**4.94**	**8.08**	**4.14**
Total VaR	**17.65**	**9.77**	**24.95**	**5.35**

	31 December 2007			
	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	1.63	2.20	4.66	1.27
Foreign exchange risk	0.08	0.23	0.53	0.04
Equity risk	0.00	0.29	3.02	0.00
Credit spread risk	4.21	3.60	8.30	2.06
Total VaR	5.92	6.32	11.00	4.28

BANKING NON-TRADING

The estimated impact of an immediate 25 basis point increase in interest rates on economic value for the years ended 31 December 2008 and 2007 is shown below (in the 2007 Form 20-F a 200 basis point increase was used). Economic value is defined as the present value of the non-trading portfolios concerned. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. No currency breakdown has been provided as most of the exposure is in pounds sterling. These calculations are made monthly using assumptions regarding the maturity of interest rate insensitive assets and liabilities. The portfolio is updated monthly to reflect any changes in the relationship between customer behaviour and the level of interest rates.

This is a risk-based disclosure and the amounts below would be amortised in the income statement over the duration of the portfolio. During 2008, management revised the basis of reporting banking non-trading to a value at risk measure to reflect better the internal measurement used to control this exposure. The decrease compared to 2007 is due to the impact on retail balances of significant cuts in base rate during the last few months of 2008. In view of the unprecedented low interest rate environment in 2009, the assumptions underlying this particular risk measure are under review and likely to change.

TABLE 1.5: BANKING NON-TRADING

	31 December 2008 £m	31 December 2007 £m
Reduction in value	**(158)**	8

INSURANCE PORTFOLIOS

The Group s market risk exposure in respect of insurance activities described above is measured using European Embedded Value (EEV) as a proxy for economic value. The pre-tax sensitivity of EEV to standardised market stresses is shown below for the years ended 31 December 2008 and 2007. Foreign exchange risk arises predominantly from overseas equity holdings. 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 or tracked on a daily basis.

TABLE 1.6: INSURANCE PORTFOLIOS

	31 December 2008 £m	31 December 2007 £m
Equity risk (impact of 10% fall pre-tax)	**(236)**	(248)
Interest rate risk (impact of 25 basis point reduction pre-tax)	**59**	58
Credit spread risk (impact of 25 basis point increase pre-tax)	**(82)**	(110)

MITIGATION

Various mitigation activities are undertaken across the Group to manage portfolios and 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 regularly reviews high level market risk exposure including, but not limited to, the data described above. It also makes 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 products and markets 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 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 limits set with reference to the Group s overall risk appetite and regularly reviewed by the senior asset and liability committee:

- The With Profit Fund is 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

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.

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 defined benefit 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 33 to the consolidated 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 body is the board of Scottish Widows Group Limited with the more significant risks also being subject to approval by the group executive committee and/or Lloyds Banking Group board. For the general insurance businesses the key control body is the Lloyds TSB General Insurance Limited board with the more significant risks again being subject to group executive committee and/or Lloyds Banking Group board approval. 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 would usually be priced in accordance with the underwriting assessment)
- 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.

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 the Group s 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 and that risk management is 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.

OPERATIONAL RISK

DEFINITION

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people-related or external events.

There are a number of categories of operational risk:

LEGAL AND REGULATORY RISK

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

CUSTOMER TREATMENT RISK

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate or poor customer treatment.

BUSINESS PROCESS RISK

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from inadequate or failed internal processes and systems, people-related events and deficiencies in the performance of external suppliers/service providers.

FINANCIAL CRIME RISK

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.

PEOPLE RISK

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate staff behaviour, industrial action 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.

CHANGE RISK

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 or failing to implement change effectively or realise the desired benefits.

GOVERNANCE RISK

The risk of reductions in earnings and/or value, through financial or reputational loss, from poor corporate governance at group, divisional or business unit level. Corporate governance in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

SECURITY RISK

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.

RISK APPETITE

Operational risk appetite is defined as the quantum and composition of operational risk identified in the Group and the direction in which the Group wishes to manage it.

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, including customer service requirements.

For legal and regulatory risk the Group has minimal risk appetite and seeks to operate to high ethical standards. 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

The main sources of operational risk within the Group relate to uncertainties created by the changing business, in particular the legal and regulatory environment in which financial firms operate both in the UK and overseas. As a result the most significant operational risk exposures are legal and regulatory.

Legal and regulatory exposure is driven by the significant volume of current legislation and regulation with which the Group has to comply, along with new 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. Further uncertainties arise where regulations are principles-based without the regulator defining supporting minimum standards either for the benefit of the consumer or firms. This gives rise to both the risk of retrospection from any one regulator and also to the risk of differing interpretation by individual regulators.

For legal and regulatory issues there are significant reputational impacts associated with potential censure which drive the Group s stance on appetites referred to above. There are clear accountabilities and processes in place for reviewing new and changing requirements. Each business has a nominated individual with compliance oversight responsibility under FSA rules. The role of such individuals is to advise and assist management to ensure that each business has a control structure which creates awareness of the rules and regulations to which the Group is subject, and to monitor and report on adherence to these rules and regulations.

MEASUREMENT

Throughout 2008, there was ongoing development of operational risk appetites and metrics to ensure both current and potential future operational risk exposures are understood in terms of both risk and reward potential.

The Group has comprehensive and consistent operational risk management frameworks for the timely identification, measurement, monitoring and control of operational risk.

Integral to this operational risk management framework is a hybrid approach to calculating capital to support unexpected losses. The capital model calculations are driven by internal data which captures past losses, and forward looking scenarios which value potential future risk events. External industry-wide data is collected to help with validating scenarios.

The capital model outputs are used to determine the internal capital charge for the Group which is then allocated to the businesses within the Group. Following review and approval of the operational risk management framework and capital model, the FSA has granted the banking businesses within the Group an Advanced Measurement Approach (AMA) Waiver which recognises the embedding of the operational risk framework across the businesses. The waiver allowed the Group to calculate its own regulatory capital charge for operational risk from its capital model with effect from 1 January 2008.

The intention is to extend the same methodology to the insurance businesses within the Group where regulatory capital is currently determined under the ICA requirements.

MITIGATION

The Group s operational risk management frameworks consist of five key components:

- Identification of the key operational risks facing a business area.
- Evaluation of the effectiveness of the control framework covering each of the key risks to which the business area is exposed.
- Evaluation of the non-financial exposures (e.g. reputational risk) for each of the key risks to which the business area is exposed.
- For material risks identified, an estimate of the exposure to financial losses that could result within the coming financial year, together with an estimate of losses in a stressed environment.
- For material risks identified, an estimate of exposure to high impact, low frequency events through a scenario.

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 compliance and operational 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.

FINANCIAL SOUNDNESS
DEFINITION

Financial soundness risk has three key risk components covering liquidity and funding risk; capital risk; and financial & prudential regulatory reporting, disclosure and tax risk.

LIQUIDITY AND FUNDING

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.

In recent months, the strain in the financial systems has increased substantially, leading to a significant tightening in market liquidity with the threat of a more marked deterioration in the global economic outlook and a consequent increase in recourse to liquidity schemes provided by central banks. Whilst various governments, including the UK Government, have taken substantial measures to ease the current crisis in liquidity, such as the measures announced in the UK on 8 October 2008 and 13 October 2008 (for further details on the measures announced by the UK Government see Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government), there can be no assurance that these global measures will succeed in improving the funding and liquidity of the markets in which the major banks, including Lloyds Banking Group, operate.

Consistent with regulatory requirements, the banking and insurance parts of the Group manage their liquidity independently on a stand-alone basis. Liquidity for all UK-based banking business is managed centrally. Liquidity for International banking entities are managed on a stand-alone basis Liquidity risk in the Insurance business is managed at business unit level and is not considered further in this section.

RISK APPETITE

Liquidity and funding risk appetite for the banking businesses is set by the board and reviewed on an annual basis. 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. The board reviews liquidity and funding risk on a quarterly basis.

EXPOSURE

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

A series of measures are used across the Group to monitor both short- and long-term liquidity including: ratios, cash outflow triggers, and stress test survival period triggers. Strict criteria and limits are in place to ensure marketable securities are available as part of the portfolio of highly liquid assets.

MITIGATION

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and crisis liquidity, 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 retail deposit base, accompanied by appropriate funding from the wholesale markets. 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 inter-bank 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 central banks and 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 set out on page F-79 of the consolidated financial statements 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 (Bank of England, European Central Bank, Federal Reserve Bank of New York). During 2008 the Group increased its stock of liquid assets by £47 billion to £63 billion, compared to £16 billion in 2007, which includes government securities, mortgage-backed securities, corporate and other debt securities.

MONITORING

Liquidity is actively monitored at business unit and Group level at an appropriate frequency. 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, Lloyds Banking 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 Statement 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 AUDITED INFORMATION

The information reviewed by the group executive committee, group asset and liability committee and senior asset and liability committee includes analysis set out in table 1.7.

TABLE 1.7: GROUP BALANCE SHEET

	31 December 2008 £bn	31 December 2007 £bn	**2008 % growth**
Assets			
Loans and advances to customers	**242.7**	209.8	**15.7**
Wholesale assets	**72.5**	57.7	**25.6**
Banking assets	**315.2**	267.5	**17.8**
Total assets	**436.0**	353.3	**23.4**
Liabilities			
Non-bank deposits	**170.9**	156.6	**9.1**
Wholesale funding*	**141.4**	105.1	**34.5**
Total funding	**312.3**	261.7	**19.3**
Total liabilities and shareholders equity	**436.0**	353.3	**23.4**

* Excludes repos.

GROUP RETAIL AND WHOLESALE FUNDING MIX

Wholesale assets comprise balances arising from banking business and include loans and advances to banks, trading and other financial assets at fair value through profit and loss and available-for-sale financial assets. Non-bank deposits comprise balances arising from banking businesses and include customer accounts.

The group balance sheet has grown by 23.4 per cent during 2008. The funding for this has been primarily raised in the wholesale markets with customer deposit growth of £14.4 billion.

Wholesale funding has been analysed between that monitored by the London Treasury operations and the Group s overseas Treasury operations. The wholesale funding shown excludes any repo activity.

The composition and quality of wholesale deposits are regularly reviewed by management and comprises deposits from corporates and government agencies that roll over on a regular basis and are reinvested.

TABLE 1.8: WHOLESALE FUNDING*

	As at 31 December 2008 £bn	**As at 31 December 2008 %**	As at 31 December 2007 £bn	As at 31 December 2007 %
Bank	**27.9**	**8.9**	28.6	10.9
Non-bank	**48.7**	**15.6**	39.5	15.1
Wholesale deposits	**76.6**	**24.5**	68.1	26.0
Certificates of deposit	**27.9**	**8.9**	11.3	4.3
Medium term notes	**15.8**	**5.1**	9.1	3.5

Commercial paper	**19.9**	**6.4**	17.6	6.7
Securitisation	**9.8**	**3.1**	13.3	5.1
Subordinated liabilities	**15.9**	**5.1**	11.9	4.5
London Treasury operations	**165.9**	**53.1**	131.3	50.1
Other Treasury operations	**45.2**	**14.5**	31.8	12.2
Total	**211.1**	**67.6**	163.1	62.3

* Table 1.8 excludes repo balances.

TABLE 1.9: RESIDUAL MATURITY OF LONDON TREASURY WHOLESALE FUNDING

	As at 31 December 2008 £bn	**As at 31 December 2008 %**	As at 31 December 2007 £bn	As at 31 December 2007 %
Less than one year	**127.8**	**77.0**	107.0	81.5
One to two years	**5.7**	**3.5**	5.0	3.8
Two to five years	**18.1**	**10.9**	11.1	8.5
More than five years	**14.3**	**8.6**	8.2	6.2
Total	**165.9**	**100.0**	131.3	100.0

Other Treasury operations include those businesses that are run on a stand-alone basis in jurisdictions outside London to support local banking businesses often in different time zones. The residual maturity profile of these operations is less than one year.

TABLE 1.10: RECONCILIATION OF AMOUNTS SHOWN ABOVE WITH THE STATUTORY BALANCE SHEET

2008	**London Treasury Functions £bn**	**Other Treasury Functions £bn**	**Repos £bn**	**Other Retail £bn**	**Statutory Balance Sheet £bn**
Non-bank (Customer deposits)	**48.7**	**21.0**		**101.2**	**170.9**
Deposits from banks	**27.9**	**13.7**	**24.9**		**66.5**
Debt securities in issue and trading and other liabilities at fair value through profit or loss	**73.4**	**9.1**			**82.5**
Subordinated liabilities	**15.9**	**1.4**			**17.3**
Total	**165.9**	**45.2**	**24.9**	**101.2**	**337.2**

2007	London Treasury Functions £bn	Other Treasury Functions £bn	Repos £bn	Other Retail £bn	Statutory Balance Sheet £bn
Non-bank (Customer deposits)	39.5	18.5		98.6	156.6
Deposits from banks	28.6	9.8	0.7		39.1
Debt securities in issue and trading and other liabilities at fair value through profit or loss	51.3	3.5			54.8
Subordinated liabilities	11.9				11.9
Total	131.3	31.8	0.7	98.6	262.4

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CONTRACTUAL CASH OBLIGATIONS

The following table sets out the amounts and maturities of Lloyds Banking Group s contractual cash obligations at 31 December 2008.

	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Long-term debt dated	**100**	**1,489**		**4,533**	**6,122**
Euro Medium-Term Note programme	**361**	**10,479**	**718**	**4,369**	**15,927**
Commercial paper programme	**7,882**				**7,882**
Securitisation vehicles	**15,779**	**4,604**	**2,203**	**226**	**22,812**
Finance leases	**1**	**1**		**14**	**16**
Operating leases	**216**	**375**	**272**	**774**	**1,637**
Capital commitments	**143**	**30**			**173**
Other purchase obligations	**697**	**1,038**	**379**	**224**	**2,338**
	25,179	**18,016**	**3,572**	**10,140**	**56,907**

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 £525 million to these schemes in 2009.

At 31 December 2008, Lloyds Banking Group also had £11,134 million of preferred securities and undated subordinated liabilities outstanding.

At 31 December 2008, the principal sources of 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

A table setting out the amounts and maturities of Lloyds Banking Group s other commercial commitments at 31 December 2008 is included in note 49 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 £10,382 million at 31 December 2008 (with £6,255 million expiring within one year; £2,055 million between one and three years; £1,429 million between three and five years; and £643 million over five years).

Lloyds Banking Group s banking businesses are also exposed to liquidity risk through the provision of securitisation facilities to certain corporate customers. At 31 December 2008, Lloyds Banking Group offered securitisation facilities to its corporate and financial institution client base through its conduit securitisation vehicle, Cancara. This is funded in the global asset-backed commercial paper market. The assets and obligations of Cancara 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.

As at 31 December 2008 Cancara had exposures of £12,615 million, primarily loans and investments (see page F-37). Lloyds TSB Bank provided asset-backed commercial paper liquidity support facilities of £13,185 million.

Lloyds Banking Group has securitised part of its residential mortgage portfolio by transferring beneficial interests in those mortgages to special purpose entities which issue floating rate debt securities. At 31 December 2008 the total amount of residential mortgages subject to securitisation was £34,293 million in respect of which external funding at the year end amounted to £9,824 million. 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. For further details, see note 19 to the consolidated financial statements.

Within Lloyds Banking Group s insurance and investments 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.

CAPITAL

Capital risk is defined as the risk that the Group has insufficient capital to provide a sufficient resource to absorb predetermined levels of losses or that the capital structure is inefficient.

RISK APPETITE

Capital risk appetite is set by the board and reported through various metrics that enable the Group to manage capital constraints and shareholder expectations. The chief executive, assisted by the group asset and liability committee, regularly reviews performance against risk appetite. The board formally reviews capital risk on an annual basis.

EXPOSURE

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 policy is focused on optimising value for shareholders.

MEASUREMENT

The Group s regulatory capital is divided into tiers defined by the European Community Banking Consolidation Directive as implemented in the UK by the Financial Services Authority s General Prudential Sourcebook. Tier 1 capital comprises mainly shareholders equity, tier 1 capital instruments 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. During 2008 the FSA has defined core tier 1 capital. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and available-for-sale financial assets. Tier 2 capital comprises qualifying subordinated debt after deducting 50 per cent of the excess of expected loss over accounting provisions and certain securitisation positions. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. Total capital is reduced by 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 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. The unpredictable nature of movements in the value of the investments supporting the long-term assurance funds could cause the amount of qualifying tier 2 capital to be restricted because of falling tier 1 resources. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

The FSA sets Individual Capital Guidance (ICG) for each UK bank calibrated by references to its Capital Resources Requirement (CRR), broadly equivalent to 8 per cent of risk-weighted assets and thus representing the capital required under Pillar 1 of the Basel II framework.

Also a key input into the FSA s ICG setting process (which addresses the requirements of Pillar 2 of the Basel II framework) is each bank s Internal Capital Adequacy Assessment Process. The FSA s approach is to monitor the available capital resources in relation to the ICG requirement. The Group has been given an ICG by the FSA and the board has also agreed a formal buffer to be maintained in addition to this requirement. Any breaches of the formal buffer must be notified to the FSA, together with proposed remedial action. No such notification has been made in 2008. The FSA has made it clear that each ICG remains a confidential matter between each bank and the FSA.

In the context of the current market conditions the FSA has made further statements to explain the approach it has taken to the capital framework; these include core tier 1 and tier 1 targets under stressed conditions.

The Group has developed procedures meant to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite.

In addition to the regulatory framework, the Group also operates an internal capital framework.

MITIGATION

The Group is also able to raise equity either via a rights issue, placing or an open offer. A share placing was undertaken in September 2008 and the board also announced in October 2008 a further placing and open offer to shareholders as part of its participation in the recapitalisation of the banking sector. The Group is able to raise funds by issuing subordinated liabilities. The cost and availability of subordinated liability finance are influenced by credit ratings. A reduction in these ratings could increase the cost and could reduce market access.

MONITORING

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group s budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the group asset and liability committee. 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 is made to the senior asset and liability committee and to the group asset and liability committee.

CAPITAL RATIOS (BASEL II)

	31 December 2008 £m	31 December 2007 £m
Tier 1		
Share capital and reserves	**9,573**	12,663
Regulatory post-retirement benefit adjustments	**435**	704
Other items	**(108)**	
Available-for-sale revaluation reserve and cash flow hedging reserve	**2,997**	402
Goodwill	**(2,256)**	(2,358)
Other deductions	**(1,099)**	(929)
Core tier 1 capital	**9,542**	10,482
Preference share capital	**1,966**	1,589
Innovative tier 1 capital instruments*	**3,169**	1,474
Less: restriction in amount eligible	**(976)**	
Total tier 1 capital	**13,701**	13,545
Tier 2		
Undated loan capital	**5,189**	4,457
Dated loan capital	**5,091**	3,441
Innovative capital restricted from tier 1	**976**	
Collectively assessed provisions	**21**	12
Available-for-sale revaluation reserve in respect of equities	**8**	12
Other deductions	**(1,099)**	(928)
Total tier 2 capital	**10,186**	6,994
Total tier 1 and tier 2 capital	**23,887**	20,539
Supervisory deductions		
Life and pensions businesses	**(4,208)**	(4,373)
Other deductions	**(550)**	(491)
Total supervisory deductions	**(4,758)**	(4,864)
Total capital	**19,129**	15,675
Risk-weighted assets (unaudited)		
Credit risk	**149,638**	127,228
Market and counterparty risk	**8,513**	5,280
Operational risk	**12,339**	10,059
Total risk-weighted assets	**170,490**	142,567
Risk asset ratios (unaudited)		
Core tier 1	**5.6%**	7.4%
Tier 1	**8.0%**	9.5%
Total capital	**11.2%**	11.0%

* A firm is permitted to include innovative tier 1 capital in its tier 1 capital resources for the purposes of GENPRU1.2 (adequacy of financial resources) but is required to exclude these amounts from tier 1 for the purposes of meeting the main BIPRU firm Pillar 1 rules.

FINANCIAL AND PRUDENTIAL REGULATORY REPORTING, DISCLOSURE AND TAX

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 and the failure to disclose information on a timely basis about the Group.

RISK APPETITE

The risk appetite is set by the board and reviewed on an annual basis. It includes the avoidance of the need for restatement of published financial and prudential regulatory data, public disclosures about the Group s financial, including tax, performance and its legal constitution.

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 present and detect financial reporting fraud and to manage the Group s tax exposure.

MITIGATION

The Group maintains a system of internal controls, which are designed to be consistently applied, and to provide a reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements, prudential regulatory reporting and tax returns in accordance with International Financial Reporting Standards, statutory and regulatory requirements.

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 is undertaken and 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 of 2002; it 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 emerging regulation and legislation.

FUTURE CHANGES TO REGULATORY CAPITAL RULES

The regulatory capital regime is subject to ongoing review and development by the regulator. The Group continues to work with the regulator to assess the impact on the Group s regulatory capital requirements and resources.

LIFE ASSURANCE BUSINESSES

At 31 December 2008, the principal subsidiary involved in the Group s life assurance operations was Scottish Widows plc (Scottish Widows), which holds the only large With Profit Fund managed by Lloyds Banking Group.

BASIS OF DETERMINING REGULATORY CAPITAL OF THE LIFE ASSURANCE BUSINESSES

AVAILABLE CAPITAL RESOURCES

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the FSA. Different rules apply depending on the nature of the fund, as detailed below.

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. 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.

Realistic basis. The FSA requires each life assurance company which contains a With Profit Fund in excess of £500 million, including Scottish Widows, to carry out a realistic valuation of that fund. The word realistic in this context reflects the terminology used for reporting to the FSA and is an assessment of the financial position of a with-profits fund calculated under a prescribed methodology.

The valuation of with-profits assets in a with-profits fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profits business written in a with-profits fund (a relatively small amount of business in the case of Scottish Widows), it includes the present value of the anticipated future release of the prudent margins for adverse deviation. The realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities is carried out using a stochastic simulation model which values 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 set out in the section entitled Options and guarantees .

REGULATORY CAPITAL REQUIREMENTS

Each life assurance 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, 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 regulatory capital requirement is deducted from the available capital resources to give statutory excess capital .

For Scottish Widows, no amount is required to cover the impact of stress tests on the actuarial reserves. However, a further test is required in respect of the With Profit Fund, which compares the level of realistic excess capital to the statutory excess capital of the With Profit Fund. In circumstances where the realistic excess capital position is less than statutory excess capital , the Company is required to hold additional capital to cover the shortfall, but only to the extent it exceeds the value, calculated in a prescribed way, of internal transfers from the With Profit Fund. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component. 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 determination of realistic liabilities of the With Profit Fund in respect of Scottish Widows includes the value of internal transfers expected to be made from the With Profit Fund to the Non-Participating Fund of Scottish Widows. These internal transfers include charges on policies where the associated costs are borne by the Non-Participating Fund. The With-Profits Insurance Capital Component is 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 Non-Participating Fund.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS AUDITED INFORMATION
CAPITAL STATEMENT

The following table provides more detail regarding the sources of capital in the life assurance business. The figures quoted are based on management s current expectations pending completion of the annual financial return to the FSA. The figures allow for an anticipated transfer of £110 million from the Long Term Fund to the Shareholder Fund as at 31 December 2008.

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2008					
Assets attributable to the shareholder held outside the long-term funds				**862**	**862**
Assets attributable to the shareholder held within the long-term funds		**2,562**	**2,562**		**2,562**
Total shareholders funds		**2,562**	**2,562**	**862**	**3,424**
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	**293**		**293**		**293**
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities		**(708)**	**(708)**	**(581)**	**(1,289)**
Adjustment to include estimated realistic liabilities payable to the shareholder	**(406)**		**(406)**		**(406)**
Adjustment to replace realistic liabilities with statutory liabilities	**811**		**811**		**811**
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	**(49)**		**(49)**		**(49)**
Qualifying loan capital				**604**	**604**
Available capital resources	**649**	**1,854**	**2,503**	**885**	**3,388**

The figures shown above for available capital resources within the insurance business relate to Scottish Widows plc only. The estimated total additional resources relating to the other life assurance subsidiaries within the Group as at 31 December 2008 are £310 million.

The comparative position as at 31 December 2007 was as follows (again, relating to Scottish Widows plc only):

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2007					
Assets attributable to the shareholder held outside the long-term funds				956	956
Assets attributable to the shareholder held within the long-term funds		2,343	2,343		2,343
Total shareholders funds		2,343	2,343	956	3,299
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	569		569		569

Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities		(435)	(435)	(602)	(1,037)
Adjustment to include estimated realistic liabilities payable to the shareholder	(634)		(634)		(634)
Adjustment to replace realistic liabilities with statutory liabilities	3,695		3,695		3,695
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(23)		(23)		(23)
Qualifying loan capital				541	541
Available capital resources	3,607	1,908	5,515	895	6,410

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS AUDITED INFORMATION

CONSTRAINTS OVER AVAILABLE CAPITAL RESOURCES

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 of Transfer) 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 of Transfer 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 in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2008, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,854 million (31 December 2007: £1,908 million) and the estimated value of the Support Account was £200 million (31 December 2007: £827 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 of Transfer 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 2008, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £3,603 million (31 December 2007: £4,026 million) and the estimated combined value of the Support Account and Further Support Account was £2,584 million (31 December 2007: £2,834 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 2008 is £162 million (31 December 2007: £183 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.

MOVEMENTS IN REGULATORY CAPITAL

The movements in Scottish Widows plc s available capital resources can be analysed as follows:

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2007	3,607	1,908	5,515	895	6,410
Changes in assumptions used to measure life assurance liabilities	**15**	**(29)**	**(14)**		**(14)**
Dividends and capital transfers		**(110)**	**(110)**	**(110)**	**(220)**
Changes in regulatory requirements					
New business and other factors	**(2,973)**	**85**	**(2,888)**	**100**	**(2,788)**
As at 31 December 2008	**649**	**1,854**	**2,503**	**885**	**3,388**

The primary reasons for the movement in total available capital resources during the year are as follows:

WITH PROFIT FUND

Available capital in the With Profit Fund has decreased from £3,607 million at 31 December 2007 to an estimated £649 million at 31 December 2008. The key driver is investment market performance.

NON-PARTICIPATING FUND

Available capital in the Non-Participating Fund has decreased from £1,908 million at 31 December 2007 to an estimated £1,854 million at 31 December 2008. This is primarily a result of the anticipated transfer from the Non-Participating Fund to the Shareholder Fund at the year end of £110 million, and market movements offset by the return generated from the business.

SHAREHOLDER FUND

During 2008, dividends of £220 million were paid.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS AUDITED INFORMATION

FINANCIAL INFORMATION CALCULATED ON A REALISTIC BASIS

The estimated financial position of the With Profit Fund of Scottish Widows at 31 December 2008, calculated on a realistic basis, is given in the following table, in the form reported to the FSA. As a result of the capital support arrangements, it is considered appropriate to also disclose the estimated realistic financial position of the Long Term Fund of Scottish Widows as a whole, which consists of both the With Profit Fund and the Non-Participating Fund.

	31 December 2008		31 December 2007	
	With Profit Fund £m	**Long Term Fund £m**	With Profit Fund £m	Long Term Fund £m
Realistic value of assets of fund	**13,155**	**16,665**	16,793	21,005
Support arrangement assets	**362**		1,010	
Realistic value of assets available to the fund	**13,517**	**16,665**	17,803	21,005
Realistic value of liabilities of fund	**(13,268)**	**(13,062)**	(16,858)	(16,979)
Working capital for fund	**249**	**3,603**	945	4,026
Working capital ratio for fund	**1.8%**	**21.6%**	5.3%	19.2%

Subsequent to completion of the Group s consolidated financial statements, final revisions to the Scottish Widows realistic asset and liability values led to changes in the working capital ratio for the With Profit Fund. The actual year end working capital ratio for the With Profit Fund was 1.9 per cent with the Long Term Fund unchanged at 21.6 per cent.

The financial information calculated on a realistic basis reconciles to the capital statement as follows:

	31 December 2008		31 December 2007	
	With Profit Fund £m	**Long Term Fund £m**	With Profit Fund £m	Long Term Fund £m
Available regulatory capital	**649**	**2,503**	3,607	5,515
Support arrangement assets	**362**		1,010	
Adjustments to replace statutory liabilities with realistic liabilities	**(811)**	**(779)**	(3,695)	(3,575)
Adjustments to include the value of future profits recognised in respect of Non-Participating business written in the With Profit Fund	**49**	**49**	23	23
Recognition of future profits allowable for realistic capital purposes		**1,830**		2,063
	249	**3,603**	945	4,026

Analysis of policyholder liabilities in respect of the Group s life assurance business:

	Scottish Widows plc With Profit Fund (in accordance with FRS 27) £m	**Other long-term funds £m**	**Total life business £m**
As at 31 December 2008			
With Profit Fund liabilities	**13,293**		**13,293**

Unit-linked business (excluding that accounted for as investment contracts)		**11,480**	**11,480**
Other life assurance business		**8,364**	**8,364**
Insurance and participating investment contract liabilities	**13,293**	**19,844**	**33,137**
Non-participating investment contract liabilities		**14,243**	**14,243**
Total policyholder liabilities	**13,293**	**34,087**	**47,380**

	Scottish Widows plc With Profit Fund (in accordance with FRS 27) £m	Other long-term funds £m	Total life business £m
As at 31 December 2007			
With Profit Fund liabilities	16,404		16,404
Unit-linked business (excluding that accounted for as investment contracts)		14,282	14,282
Other life assurance business		6,714	6,714
Insurance and participating investment contract liabilities	16,404	20,996	37,400
Non-participating investment contract liabilities		18,197	18,197
Total policyholder liabilities	16,404	39,193	55,597

CAPITAL SENSITIVITIES

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 FUND

The with-profits realistic liabilities and the available capital for the With Profit Fund 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.

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 Fund is partly mitigated by the actions that can be taken by management.

OTHER LONG-TERM FUNDS

Outside the With Profit Fund, 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 assurance contracts. In addition, poor cost control would gradually depreciate 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 actuarial reserves are invested across a range of investment categories including fixed interest securities, equities, properties and cash. The mix of investments is determined in line with the policy of the Group to minimise 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

The Group has sold insurance products that contain options and guarantees, both within the With Profit Fund and in other funds.

OPTIONS AND GUARANTEES WITHIN THE WITH PROFIT FUND

The most significant options and guarantees provided from within the With Profit Fund 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 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 2008 of £2.0 billion (2007: £1.7 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 the With Profit Fund 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 2008, the 10 year equity-implied at-the-money assumption was set at 34.6 per cent (31 December 2007: 25.5 per cent). The assumption for property volatility was 15 per cent (31 December 2007: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 16 per cent (31 December 2007: 11 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 FUND OF SCOTTISH WIDOWS

Certain personal pension policyholders, 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 £65 million (31 December 2007: £65 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 £11 million.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INVESTMENT PORTFOLIO, MATURITIES, DEPOSITS, SHORT-TERM BORROWINGS

Available-for-sale financial assets and trading securities and other financial assets at fair value through profit or loss

The following table sets out the book values and valuations of the Group s debt securities, treasury and other eligible bills and equity shares at 31 December for each of the three years indicated.

	2008 Book value £m	**2008 Valuation £m**	2007 Book value £m	2007 Valuation £m	2006 Book value £m	2006 Valuation £m
Available-for-sale financial assets						
Securities of the US treasury and US government agencies	**358**	**358**	319	319	387	387
Other government securities	**510**	**510**			6	6
Other public sector securities	**12**	**12**	5	5	189	189
Bank and building society certificates of deposit	**9,602**	**9,602**	1,825	1,825	1,615	1,615
Mortgage-backed securities	**4,429**	**4,429**	6,050	6,050	5,662	5,662
Other asset-backed securities	**4,956**	**4,956**	4,071	4,071	4,721	4,721
Corporate and other debt securities	**6,590**	**6,590**	6,270	6,270	4,817	4,817
Equity shares	**41**	**41**	29	29	15	15
Treasury bills and other eligible bills	**29,209**	**29,209**	1,627	1,627	1,766	1,766
	55,707	**55,707**	20,196	20,196	19,178	19,178
Trading securities and other financial assets at fair value through profit or loss						
Securities of the US treasury and US government agencies	**258**	**258**	38	38	138	138
Other government securities	**7,106**	**7,106**	4,872	4,872	8,668	8,668
Other public sector securities	**18**	**18**			44	44
Bank and building society certificates of deposit	**433**	**433**	811	811	573	573
Mortgage-backed securities	**369**	**369**	157	157	538	538
Other asset-backed securities	**1,342**	**1,342**	1,927	1,927	1,456	1,456
Corporate and other debt securities	**11,656**	**11,656**	17,171	17,171	17,316	17,316
Equity shares	**23,274**	**23,274**	31,746	31,746	38,127	38,127
	44,456	**44,456**	56,722	56,722	66,860	66,860

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 2008 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 %
Available-for-sale financial assets								
US treasury and US government agencies	**8**	**2.9**	**122**	**3.1**	**228**	**3.0**		
Other government securities			**8**	**0.0**			**502**	**0.8**
Other public sector securities	**12**	**12.1**						
Bank and building society certificates of deposit	**9,602**	**1.9**						
Mortgage-backed securities	**193**	**2.2**	**3,201**	**2.4**	**810**	**2.6**	**225**	**3.3**
Other asset-backed securities	**427**	**1.8**	**1,736**	**2.1**	**2,412**	**3.0**	**381**	**3.4**
Corporate and other debt securities	**629**	**2.5**	**3,777**	**2.5**	**1,843**	**2.3**	**341**	**3.3**
Treasury bills	**29,209**	**0.7**						
	40,080		**8,844**		**5,293**		**1,449**	
Trading securities and other financial assets at fair value through profit or loss								
US treasury and US government agencies			**102**	**3.1**	**123**	**4.5**	**33**	**4.0**
Other government securities	**34**	**2.7**	**964**	**3.8**	**1,343**	**3.9**	**4,765**	**4.0**
Other public sector securities			**3**	**9.0**			**15**	**7.3**
Bank and building society certificates of deposit	**433**	**5.7**						
Mortgage-backed securities			**20**	**4.8**	**39**	**5.5**	**310**	**6.4**
Other asset-backed securities			**31**	**7.4**	**110**	**13.4**	**1,201**	**5.9**
Corporate and other debt securities	**453**	**4.0**	**1,761**	**4.4**	**2,786**	**5.1**	**6,656**	**5.0**
	920		**2,881**		**4,401**		**12,980**	

The Group s investment holdings at 31 December 2008 include £34,550 million due from the UK Government and its agencies (principally in relation to treasury bills), £7,721 million due from HBOS plc and its subsidiaries, £1,549 million due from SLM Corporation (commonly known as Sallie Mae), £1,385 million due from the Japanese Government and its agencies, £1,325 million due from the European Investment Bank, £1,170 million due from the Newport Holdings group, £1,093 million due from the Invesco group and £953 million due from the Barclays PLC group.

MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AS AT 31 DECEMBER 2008

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis as at 31 December 2008.

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
Loans and advances to banks	**35,455**	**5,355**	**106**	**40,916**
Loans and advances to customers:				
Mortgages	**3,901**	**14,722**	**96,020**	**114,643**
Other personal lending	**13,720**	**9,992**	**1,606**	**25,318**
Financial, business and other services	**18,496**	**9,646**	**7,604**	**35,746**
Lease financing	**329**	**978**	**3,313**	**4,620**
Hire purchase	**2,377**	**2,694**	**224**	**5,295**
Other	**25,711**	**19,269**	**15,702**	**60,682**
Total loans	**99,989**	**62,656**	**124,575**	**287,220**
Of which:				
Fixed interest rate	**56,865**	**29,641**	**55,527**	**142,033**
Variable interest rate	**43,124**	**33,015**	**69,048**	**145,187**

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.

	2008 Average balance £m	**2008 Average rate %**	2007 Average balance £m	2007 Average rate %	2006 Average balance £m	2006 Average rate %
Non-interest bearing demand deposits	**3,793**		3,899		4,112	
Interest-bearing demand deposits	**47,985**	**1.28**	46,124	1.80	43,236	1.27
Savings deposits	**84,756**	**3.60**	77,834	3.90	68,942	3.39
Time deposits	**18,272**	**6.94**	18,090	6.73	16,373	5.19
Total average deposits	**154,806**	**3.19**	145,947	3.48	132,663	2.82

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 2008 individually in excess of US $100,000 (or equivalent in another currency) by time remaining to maturity.

	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**
Certificates of deposit	**30,616**	**876**	**1,673**	**41**	**33,206**
Time deposits	**46,291**	**3,746**	**5,554**	**3,000**	**58,591**
Total	**76,907**	**4,622**	**7,227**	**3,041**	**91,797**

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 and promissory notes and securitisation notes 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.

	2008 £m	2007 £m	2006 £m
Liabilities in respect of securities sold under repurchase agreements			
Balance at the year end	**24,980**	733	2,521
Average balance for the year	**5,749**	3,222	5,982
Maximum balance during the year	**24,980**	3,728	10,119
Average interest rate during the year	**4.4%**	4.8%	4.4%
Interest rate at the year end	**3.7%**	5.2%	4.6%

Certificates of deposit issued

Balance at the year end	**33,207**	14,995	25,244
Average balance for the year	**23,082**	24,085	23,289
Maximum balance during the year	**33,207**	30,467	27,510
Average interest rate during the year	**4.1%**	5.3%	4.7%
Interest rate at the year end	**2.2%**	5.6%	5.2%
Commercial paper and promissory notes			
Balance at the year end	**20,644**	17,388	13,067
Average balance for the year	**21,520**	14,325	12,004
Maximum balance during the year	**28,957**	17,404	13,458
Average interest rate during the year	**3.5%**	5.3%	4.6%
Interest rate at the year end	**0.8%**	2.3%	4.0%
Securitisation notes			
Balance at the year end	**10,050**	12,501	10,048
Average balance for the year	**10,182**	11,881	1,009
Maximum balance during the year	**12,707**	13,259	10,048
Average interest rate during the year	**4.1%**	5.2%	6.0%
Interest rate at the year end	**2.8%**	5.2%	5.0%

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 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.

The board usually meets at least nine times a year. 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.

During 2008, Dr Tracy Long, of Boardroom Review, conducted a formal evaluation of the performance of the board, its committees and individual directors. Directors were invited to comment, through questionnaires and interviews, and Dr Long s report was subsequently reviewed and discussed by the board. Where areas for improvement were identified, action has been agreed.

The chairman s performance was evaluated by the non-executive directors, taking account of the views of executive directors. This appraisal was discussed at a meeting of the non-executive directors, led by the senior independent director, without the chairman being present.

The remuneration committee reviewed the performance of the chairman, the group chief executive and the other group executive directors, when considering their remuneration arrangements. The nomination committee reviewed the performance of all the directors and the independence of non-executive directors. Like all board committees, the nomination committee and remuneration committee report to the board on their deliberations, including the results of the performance and independence evaluations.

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 training and updates on particular issues are arranged as appropriate.

The directors and senior management of Lloyds Banking Group plc are:

SIR VICTOR BLANK♦♦ ++

Chairman

Joined the board in 2006 as deputy chairman and became chairman in May 2006. Former partner in Clifford-Turner (now Clifford Chance) from 1969 to 1981 and chairman and chief executive of Charterhouse until 1997. Director of The Royal Bank of Scotland from 1985 to 1993 and of GUS from 1993 to 2006 (chairman from 2000). Chairman of Trinity Mirror from 1999 to 2006. A member of the Financial Reporting Council from 2002 to 2007 and a member of the Council of Oxford University from 2000 to 2007. A senior adviser to the Texas Pacific Group and appointed by the Prime Minister as a Business ambassador. Chairs two charities, WellBeing of Women and UJS Hillel, as well as the Council of University College School. Aged 66

WOLFGANG C G BERNDTX♦

Joined the board in 2003. Joined Procter and Gamble in 1967 and held a number of senior and general management appointments in Europe, South America and North America, before retiring in 2001. A non-executive director of Cadbury, GfK AG and MIBA AG. Aged 66

EWAN BROWN CBE FRSE *+ (retiring at the annual general meeting in 2009)

Joined the board in 1999 and was chairman of Lloyds TSB Scotland until May 2008. Joined Noble Grossart in 1969 and was an executive director of that company until December 2003. A non-executive director of Noble Grossart and Stagecoach Group, chairman of Creative Scotland 2009, senior governor of the Court of the University of St Andrews and vice chairman of the Edinburgh International Festival. A former chairman of tie and non-executive director of John Wood Group. Aged 67

PHILIP N GREENX*

Joined the board in May 2007. Appointed chief executive of United Utilities in 2006. Former chief executive of Royal P&O Nedlloyd from 2003 to 2005. Previously held senior positions in DHL from 1990 to 1999, becoming chief operating officer for Europe and Africa in 1994, and the Reuters Group from 1999 to 2003, becoming chief operating officer in 2001. A director of Business in the Community and the UK Commission for Employment and Skills. A trustee of the Philharmonia Orchestra. Aged 55

SIR JULIAN HORN-SMITHX♦ **+**

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 and deputy chief executive officer from 2005. Previously held positions in Rediffusion from 1972 to 1978, Philips from 1978 to 1982 and Mars GB from 1982 to 1984. A non-executive director of Digicel Group, a member of the Altimo International advisory board and a senior adviser to UBS in relation to the global telecommunications sector. A former chairman of The Sage Group. Aged 60

MANAGEMENT AND EMPLOYEES

LORD LEITCHX⁕♦+

Joined the board in 2005. 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 and Intrinsic Financial Services and a non-executive director of Paternoster. Former chairman of the National Employment Panel. Aged 61

SIR DAVID MANNING GCMG CVOX♦ +

Joined the board on 1 May 2008. Entered the Foreign and Commonwealth Office in 1972 and held senior appointments, including HM ambassador to Israel between 1995 and 1998, foreign policy adviser to the Prime Minister from 2001 to 2003 and HM ambassador to the USA from 2003 to 2007. A non-executive director of BG Group and Lockheed Martin UK Holdings. Aged 59

CAROLYN J McCALL OBEX

Joined the board on 1 October 2008. Appointed group chief executive of Guardian Media Group in 2006 having joined that organisation in 1986 and held a number of senior and general management appointments before becoming a director in 2000. Chair of Opportunity Now and a director of Business in the Community. Aged 47

T TIMOTHY RYAN, JRX***+**

Joined the board on 1 March 2009. President and chief executive of the Securities Industry and Financial Markets Asociation. 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 and the International Foundation of Electoral Systems 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. Aged 64

MARTIN A SCICLUNAX****+**

Joined the board on 1 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. A non-executive director of Great Portland Estates. A member of the council of Leeds University and a governor of Berkhamsted School. Aged 58

ANTHONY WATSON CBEX

Joined the board on 2 April 2009. Previously chief executive of Hermes Pensions Management. Held a number of senior appointments in AMP Asset Management from 1991 to 1998. A former chairman of the Strategic Investment Board (Northern Ireland). A non-executive director of Hammerson, Vodafone and Witan Investment Trust and chairman of Marks and Spencer Pension Trust, Asian Infrastructure Fund and Lincoln s Inn investment committee. A former chairman of MEPC and a former member of the Financial Reporting Council. Aged 64

J ERIC DANIELS

Group Chief Executive

Joined the board in 2001 as group executive director, UK retail banking before his appointment as group chief executive in June 2003. Served with Citibank from 1975 and held a number of senior and general management appointments in the USA, South America and Europe before becoming chief operating officer of Citibank Consumer Bank in 1998. Following the Citibank/Travelers merger in 1998, he was chairman and chief executive officer of Travelers Life and Annuity until 2000. Chairman and chief executive officer of Zona Financiera from 2000 to 2001. A non-executive director of BT Group. Aged 57

ARCHIE G KANE

Group Executive Director, Insurance

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. 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. Chairman of the Association of British Insurers and a member of the Chancellor s Financial Services Global Competitiveness Group, The Takeover Panel and the Chancellor s Insurance Industry Working Group. Aged 56

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. A member of the fund-raising board of the National Society for the Prevention of Cruelty to Children, a director of Business in the Community and a director and trustee of In Kind Direct. Aged 58

TIM J W TOOKEY

Group Finance Director (from 2008)

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. Aged 46

HELEN A WEIR CBE

Group Executive Director, Retail

Joined the board in 2004 as group finance director. 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 from 1997, having joined that company in 1995, and held a senior position at McKinsey & Co from 1990 to 1995. Began her career at Unilever in 1983. A non-executive director of Royal Mail Holdings. A member of the Said Business School Advisory Board and a former member of the Accounting Standards Board. Aged 46

*Member of the audit committee **Chairman of the audit committee ♦ Member of the nomination committee ♦♦ Chairman of the nomination committee Member of the remuneration committee Chairman of the remuneration committee + Member of the risk oversight committee ++ Chairman of the risk oversight committee X Independent director   Senior independent director

MANAGEMENT AND EMPLOYEES

EMPLOYEES

As at 31 December 2008, the Group employed 58,756 people (on a full-time equivalent basis), compared with 58,078 at 31 December 2007. At 31 December 2008 56,718 employees were located in the UK, 1,061 in continental Europe, 473 in the Americas, and 504 in the rest of the world. At the same date, 29,150 people were employed in UK Retail Banking, 5,147 in Insurance and Investments, 15,385 in Wholesale and International Banking, and 9,074 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.

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 .

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.

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 2008.

REMUNERATION DECISIONS FOR 2008/2009 KEY HIGHLIGHTS

In 2009, the Group s remuneration package will continue to have the same main elements as for 2008:

- base salary
- annual incentive
- long-term incentive plan

In addition, executive directors participate in pension arrangements and receive benefits such as life assurance and medical insurance.

The following key decisions have been made for 2008/2009 remuneration:

- at their own request, the executive directors will not be awarded any bonus for 2008
- base salaries for executive directors frozen at 2008 levels
- reduced the maximum level of incentives from 2008 levels by 175 per cent of salary
- strengthened the role for non-financial measures, introducing a balanced scorecard into the long-term incentive plan focused on the HBOS integration
- increased the role of risk-adjusted economic profit, by introducing it as a measure in the long-term incentive plan, in addition to its current use in the annual incentive
- changed the annual incentive plan so that the payment is deferred over three years, and subject to clawback if the performance on which the incentive is based is found not to be sustainable
- determined that, from April 2012, executive directors will no longer participate in the final salary pension plan

The approximate make-up of the main components of the Group s new package for executive directors on an expected value basis is shown below.

The package is designed to encourage a long-term and risk-based focus:

- Salary is a significant proportion of the total package, avoiding excessive leverage
- All incentives will be paid on a deferred basis over three years
- Deferred annual incentive is subject to clawback, i.e. is not paid if performance on which the incentive is based is found to be unsustainable
- A combination of financial and non-financial measures encourages a long-term focus
- Economic profit, which is a risk-adjusted profit measure, is a core financial target

The Group believes that these arrangements are well aligned with the Financial Services Authority s draft Code of Practice on Remuneration.

COMPENSATION

GOVERNANCE AND RISK MANAGEMENT

An essential component of the Group s 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 remuneration committee reviews the remuneration policy for the top management group. The committee s role is to ensure that members of the executive management are provided with appropriate incentives to encourage them to enhance the performance of the Group and that they are rewarded for their individual contribution to the success of the organisation.

The committee advises on major changes of employee benefits schemes and 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 exceeds a specified amount, currently £350,000.

All the independent non-executive directors are invited to attend meetings if they wish, and they receive the minutes and have the opportunity to comment and 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.

The committee met on nine occasions during 2008, and the members were as follows:

Dr Wolfgang Berndt (chairman)

Sir Victor Blank

Mr Philip Green

Sir Julian Horn-Smith

Sir David Manning (from 1 May 2008)

The Group welcomed Sir David Manning to the committee in May 2008, which was the only change to the committee membership during the year.

The committee retains independent consultants to provide advice on specific matters according to their particular expertise. Towers Perrin, Hewitt New Bridge Street and Kepler Associates were retained by the committee during 2008 to advise on various matters relating to executive remuneration. In addition, PricewaterhouseCoopers LLP (PwC) were also retained in 2008 specifically to support the committee with a one-off project to review executive remuneration arrangements in light of the acquisition of HBOS, given their particular expertise in relation to the remuneration aspects of transactions. In recognition that PwC are also the auditors to the Lloyds Banking Group and to mitigate any threat to audit independence, Kepler Associates continue to be retained as the remuneration committee s primary independent advisers, and were commissioned to provide comment on PwC s advice.

In addition to their advice on executive remuneration, during 2008 Towers Perrin also provided market remuneration data as well as other remuneration consulting services to the Group, Hewitt New Bridge Street provided pension consulting services and PwC were the Group s auditors.

During 2008, Alithos Limited continued to provide information on behalf of the committee for the testing of the total shareholder return (TSR) (calculated by reference to both dividends and growth in share price) performance conditions for the Group s long-term incentive schemes.

Mr Daniels, Mrs Risley (Group Human Resources Director), Mr Farley (Reward & Employment Policy Director) and Ms Kemp (HR Director, Total Reward) provided guidance to the committee (other than for their own remuneration).

The remuneration committee takes an interest in ensuring that appropriate remuneration and governance arrangements are in place throughout the organisation, with the Group functions providing an oversight role in the development of remuneration policy and practice below the senior executive population. In particular, divisional remuneration decisions are subject to independent oversight from the human resources function and the appointment and remuneration for risk officers in the divisions is reviewed in conjunction with the chief risk officer for the Group.

During 2008, the committee received a review of the Group s remuneration practices against a number of criteria including customer, shareholder alignment, conflict of interest and risk. This was prior to the review of practices requested by the Financial Services Authority (FSA) in October 2008. In general, the review found that there was good alignment between remuneration practices and the policy objectives. However, changes are being implemented to the practice in some areas of the business. In particular the Group had put in place for those employees in its Wholesale and International Banking division a bonus deferral plan appropriate to the roles they perform. As described above the Group has also implemented a deferral arrangement for senior executives, and has increased the use of its risk-adjusted economic profit measure in its incentive plans.

Following the FSA s approach to a number of major UK banks in October 2008, the Group submitted an analysis of its current remuneration policies against their proposed good practice criteria. The assessment showed a generally favourable comparison. The Group has met with representatives from the FSA and will continue to co-operate with them as they develop their updated guidance in 2009. Their draft Code of Conduct was published in March 2009. Although the Group believes its approach is well aligned with the Code of Conduct, the Group s approach has been subject to a further detailed review.

As a result of this review, and discussions with the FSA, the Group has identified some areas of governance where it will be implementing changes for the future, as part of its plan for integrating the heritage Lloyds TSB Group and HBOS businesses:

The Group will be enhancing the formal role of control functions in the oversight of remuneration. Input is already sought from the risk and finance functions into remuneration design and decisions. However, the Group believes that its governance would benefit from a more formalised role for control functions in its remuneration processes.

COMPENSATION

The Group will be reviewing the oversight of divisional remuneration. Already it applies independent oversight of divisional remuneration from the Group s centre function. During 2008, the group HR function, in conjunction with the risk function, undertook the group-wide review of remuneration practices summarised above, and the Group will be reviewing the oversight processes and governance controls relating to divisions to identify areas where they can be further strengthened. The Group s particular emphasis will be on ensuring that the linkage between good risk practices and remuneration can be robustly demonstrated.

Regulators have identified the remuneration of risk officers as one of their areas of interest. The decision on risk officer remuneration is already held at the Group s centre function. The Group will be reviewing the remuneration setting processes for all of its control functions to ensure that all potential conflicts of interest are identified and managed.

DIRECTORS REMUNERATION POLICY

The Group s remuneration policy supports its business strategy, which is based on building long-term relationships with its customers and employees, and managing the financial consequences of its business decisions across the entire economic cycle. The policy is designed to ensure that cost effective packages are provided which attract and retain executive directors and senior management of the highest calibre and motivate them to perform to the highest standards. At the same time, the objective is to align individual rewards with the Group s 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: customers, shareholders, employees, and regulators. The Group believes that this approach is in line with the Association of British Insurers best practice code on remuneration as well the draft Financial Services Authority s Code of Practice, as the policy seeks to reward long-term value creation whilst not encouraging excessive risk taking.

Summarised below is how each of these policy objectives is met by the Group s remuneration packages.

Policy objective	How achieved
Building long-term relationships	The Group builds relationships with its customers and people rather than viewing them as counterparties in a money-making transaction and will be seeking to extend its philosophy across the integrated Group. This means that working for the Lloyds Banking Group should be about more than pay. While the Group s relationships with its people means that it will pay them fairly and competitively, pay is positioned conservatively against the market and the Group will not seek to be among the highest payers in the sector. In setting pay for executive directors, the Group takes account of the terms and conditions applying to other employees of the Group. The Group s incentive measures are not just financial. Half of the annual incentive for executives is linked to a scorecard including how the Group performed against targets that measure how satisfied its customers are with it, and the extent to which its employees feel engaged with and committed to working for the Lloyds Banking Group, both of which are important foundations of a relationship-based strategy.
Managing the financial consequences of the Group s business through the economic cycle	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 business will perform through the economic cycle. Therefore, 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 it 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, a role which will be further enhanced in 2009, with its inclusion in the long-term incentive plan performance measures.
Aligning individual rewards with Group performance and shareholders	The majority of the Group s executives pay is linked to stretching performance targets through annual and long-term incentives. Performance measures on the annual incentive are directly aligned to the Group s financial and non-financial performance.

Executives are aligned with shareholders through the long-term incentive plan, which pays out based on performance against Group targets over a three year period, and which is paid in shares to improve alignment with shareholders further.

The combination of incentive plans is designed to enable executives to achieve pay levels within the top 25 per cent of comparable companies, provided that performance is also in the top 25 per cent.

Executives are required to build up a holding in Lloyds Banking Group plc shares of value equal to 1.5 times salary for executive directors (2 times salary for the group chief executive). They are expected to retain half of the net-of-tax proceeds of share plan pay-outs until they reach this target.

Finally, the Group operates tough contract provisions whereby no executive has an entitlement to more than 12 months notice, compensation on termination is limited to basic salary, and any compensation 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.

COMPENSATION

Policy objective	How achieved
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 therefore encourages executives to take a prudent approach to risk. The Group also has non-financial measures of performance against risk objectives in the plan for executives, which enables a more rounded assessment of risk-taking behaviour to be made. For the 2009 incentive the Group has increased the alignment to long-term prudent risk management by introducing deferral. For executive directors and other senior executives, any cash incentive earned will be deferred and paid-out over three years. If the performance that led to the incentive is found to be unsustainable, then this deferred portion may be forfeited. The Group pays competitively but not excessively. Its prudent approach to positioning compensation means that it reduces the incentives where excessive risk may be taken for personal gain. This means that it does not attract employees with an extreme appetite for risk. The Group has a robust governance framework with an independent remuneration committee reviewing all compensation decisions. This robust approach to governance and review is cascaded through the organisation.
Cost effective packages to attract and retain executives	The Group aims to ensure that the totality of remuneration for executive directors is competitive against its benchmark groups. These groups are other major UK banks, and also the top 20 companies in the FTSE 100, reflecting practices in comparably sized large UK companies across all sectors. The Group aims to be competitively but conservatively positioned against the market. The Group aims to choose incentive plan targets that are directly linked to the business strategy and priorities. This not only ensures alignment with company performance, but also means that the targets are meaningful to executives and therefore motivating. This ensures that incentive packages are valued by executives and therefore cost effective.

REMUNERATION FOR 2009

The remuneration committee had already started a review of executive remuneration during 2008 prior to the announcement of the HBOS acquisition. This was in the light of concerns about the competitiveness of the package, which had led to the committee making long-term incentive awards of 375 per cent of salary in 2008, above the normal maximum of 300 per cent. The scope and context of this review was naturally altered by the acquisition of HBOS and by the rapidly evolving environment in the financial services sector.

The changes introduced as a result of this review are summarised below.

SUMMARY OF REMUNERATION ELEMENTS

The key remuneration elements for 2009 as a result of the review are summarised below. Each individual element is then described in more detail in the subsequent sub-sections.

Element	Level/design for 2009	Key purpose
Base salary	Set competitively relative to FTSE 20 and banking sector competitors No increase for 2009 compared with 2008	Meet essential commitments of executive Retention
Annual incentive		Alignment with Group performance

	200 per cent of salary maximum (225 per cent for the group chief executive), as for 2008	
	Based 50 per cent on Group financial targets relating to profit before tax and economic profit	Alignment with sound risk management
	Based 50 per cent on balanced scorecard covering customers, people, risk and build franchise	Motivation of executives
	Subject to deferral with the first tranche released in 2011	
Long-term incentive plan	200 per cent of salary maximum, 175 per cent of salary less than the maximum award level in 2008, split as follows:	Alignment with shareholder interests
	120 per cent of salary Normal LTIP Award based: 50 per cent on Earnings per Share 50 per cent on Economic Profit	Alignment with sound risk management
	80 per cent of salary Integration Award based: 50 per cent on financial synergy savings 50 per cent on non-financial measures of the success of the HBOS integration	Motivation and retention of executives
Pension	A mixture of final salary and defined contribution pension arrangements	Enable executives to build long-term retirement savings
	From April 2012, executive directors with final salary pensions will move to a defined contribution pension arrangement, with no compensation	Retention

Despite the significantly increased responsibilities of the executive directors, the maximum total pay opportunity for an executive director in 2009 is reduced by 175 per cent of salary from 2008.

COMPENSATION

GENERAL CONSIDERATIONS

When deciding the approach to take for remuneration in 2009, the remuneration committee considered a range of factors. In forming the Lloyds Banking Group, the Group s senior executive team will be managing a combined business twice the size of the heritage Lloyds TSB Group, at the same time as integrating two highly complex businesses, one of which had a flawed business model. The balance sheet alone will be among the largest balance sheets in the world. There will be significant increases in workload and responsibilities. Shareholders, customers and tax-payers will want to ensure that the right team is in place, appropriately motivated and incentivised to take the Group forward, put appropriate risk management frameworks into HBOS, and deliver the value from the takeover. The terms on which senior executives have recently been appointed within the banking sector shows that shareholders remain convinced of the need to offer competitive compensation packages.

At the same time, the committee has been very aware of developments in the financial services sector and in relation to remuneration practices more widely. The committee reviewed trends in relation to base salary and incentives at other major financial firms globally, including those participating in Government funding programmes. The committee also considered the implications of the Financial Services Authority s draft code on remuneration. Finally the committee considered developments at the other UK and international banks, including the terms on which senior executives at banks were hired during 2008 (including executives departing from the heritage Lloyds TSB Group).

BASE SALARY

Basic salaries are reviewed annually, usually in December, taking into account individual performance and market information (which is provided by Towers Perrin) and then adjusted from 1 January of the following year. The remuneration committee confirmed during the 2008 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 the Group s direct competitors, namely the major UK banks. The FTSE 20 is regarded as providing a realistic and relevant comparison in terms of company size and complexity, as well as being a key market for talent.

However, in recognition of the current operating environment and in common with many of the Group s peers, base salaries for 2009 remain unchanged from the salaries set for 2008. Basic salary increases for other employees across the Group will remain in line with any market movement, but will, in general be significantly lower than in previous years.

Name	J E Daniels	A G Kane	G T Tate	T J W Tookey	H A Weir
As at 1 January 2008	£1,035,000	£590,000	£640,000	£600,000*	£625,000

* With effect from appointment on 30 October 2008.

This approach has also been applied to the chairman s salary and non-executive director fees for 2009 which remain unchanged from 2008.

ANNUAL INCENTIVE PLAN

The heritage Lloyds TSB Group annual incentive plan already had many good features, such as the combination of financial and non-financial measures, which supported the Group s prudent approach to managing risk. The Group is proposing to keep these features, while enhancing the operation of the plan in order to increase the alignment between risk and reward still further.

The remuneration committee has considered the preliminary guidance from the FSA relating to good practice criteria, and has reviewed emerging practice in other banks within the sector both in the UK and overseas. Although more than half of the Group s total incentive opportunity was already deferred, through its long-term incentive plan, it has decided that the annual incentive for executive directors should be deferred also. Consistent with the aim of ensuring that short-term financial results are only achievable sustainably, the committee has decided that the incentive will be deferred and released in tranches over a three year period. The deferral will be on the same basis as for senior staff with the first tranche being released in June 2011. The deferred incentive will be subject to 100 per cent clawback if the performance that generated the incentive is found to be unsustainable.

The maximum annual incentive opportunity remains unchanged at 200 per cent (225 per cent for Mr Daniels) of basic salary for the achievement of exceptional performance targets.

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. Introducing this deferral element further enhances these aspects of the plan.

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 are made of 300 per cent of salary with the additional 100 per cent available for circumstances that the remuneration committee deems to be exceptional. In 2008, awards were made of 375 per cent of base salary to the group chief executive and two of the executive directors for retention purposes, and in light of data reviewed by the committee which showed total remuneration to be behind median both for the FTSE 20, and the other major UK banks.

Further information viewed by the committee through 2008 continued to show that total remuneration for the executive directors was materially behind the median of the Group s peer groups, even before allowing for the increased responsibilities of running the combined bank and the magnitude of the task of integrating the two businesses.

However, there is a strong overall focus on cost control within the business, and rapid changes within the industry make it difficult to assess what will, in future, be market competitive. Therefore, the committee has determined not to seek authority from shareholders to increase the LTIP award to the level required to achieve a market median value of remuneration. Instead, the committee has determined that for 2009 the grant level for executive directors should be set at 200 per cent of base salary.

This means that, in its totality, the maximum remuneration opportunity for executive directors in 2009 will be reduced by 175 per cent of salary from the maximum awarded to a director in 2008, despite a doubling in the size of the Group, and despite the challenges ahead in integrating the businesses to create the Lloyds Banking Group.

LONG-TERM INCENTIVE PERFORMANCE MEASURES

In reviewing measures, the remuneration committee has aimed to build on existing aspects of the remuneration policy that have been successful, with a focus on long-term performance, taking appropriate account of risk. At the same time, the committee has sought to develop arrangements that motivate executives to meet the near-term objectives of integrating the two businesses.

The setting of the definitive performance targets for 2009 will be completed in time for publication prior to the annual general meeting. The committee will continue to engage with shareholders during this time and will share the detail of the performance targets once they are finalised.

Performance targets will be set by reference to analysts expectations, internal business plans, competitive performance assessments and probability modelling. Stretch performance will be equated to the remuneration committee s assessment of an upper quartile performance level or greater. Non-financial targets will be fully disclosed, and payments against them justified, in the year of vesting.

The detailed rationale for the proposed measures is set out below.

EARNINGS PER SHARE (APPLYING TO AWARD OF 60 PER CENT OF SALARY, BEING HALF THE REGULAR LTIP AWARD)

Earnings per share continues to be an important measure of the Group s profitability and ability to generate cash at a point in time. The committee has therefore decided to retain this well-recognised measure in the Group s incentive system.

ECONOMIC PROFIT (APPLYING TO AWARD OF 60 PER CENT OF SALARY, BEING HALF THE REGULAR LTIP AWARD)

Economic profit has been used as a performance measure within the heritage Lloyds TSB Group for a number of years. It has been very successful at introducing a long-term, risk-based approach to managing the Group s business. Given the increasing focus now being placed on risk-adjusted measures by shareholders and regulators, adoption of this established measure into the LTIP is felt by the committee to be a further enhancement of the alignment between the Group s remuneration and business strategy. The Group s economic profit measure is a through-the-cycle measure, which encourages prudent risk management of the Group s portfolio, considering the impact of decisions over an entire economic cycle.

Economic profit replaces relative total shareholder return within the LTIP. The committee is of the view that at the current time, with extreme market volatility and the level of disruption in the Group s peer group, TSR is not a robust performance measure. Moreover, the committee is concerned that relative TSR measures may not have been supportive of sound risk management policies during economic upswings. Indeed, such a measure can encourage a strategic herd mentality , with banks encouraged to take on more risk in order to improve the prospects of significantly out-performing their peers. Economic profit, by measuring risk-adjusted performance with targets reflecting the Company s specific risk appetite, is, in the view of the committee, a better incentive for sustainable performance.

The committee is aware that some shareholders favour relative TSR as a measure, and so will further consider its role for long-term incentive awards in 2010 and beyond during the review to be carried out later in 2009. However, it is the view of the committee that an economic profit measure is better aligned with the Financial Services Authority s draft Code of Practice criteria.

SYNERGY TARGETS (APPLYING TO AWARD OF 40 PER CENT OF SALARY, BEING 50 PER CENT OF THE INTEGRATION AWARD)

The Integration Award naturally includes a component relating to the achievement of the Group s £1,500 million synergy goal by the end of 2011. However, in order to demonstrate the credibility of the integration to the market, it is important that the trajectory of achieving the synergies, and the cost of achievement, are well balanced. Therefore, the synergy element will include targets for synergy savings in 2009 and 2010 (although awards will not ultimately vest until the end of 2011, and will be subject to an assessment by the remuneration committee at that point that the synergies have been achieved on a sustainable basis).

COMPENSATION

INTEGRATION BALANCED SCORECARD (APPLYING TO AWARD OF 40 PER CENT OF SALARY, BEING 50 PER CENT OF THE INTEGRATION AWARD)

The committee believes that an excessive focus on financial targets can potentially reward short-term actions that are detrimental to the long-term health of the business. For this reason a balanced scorecard has been operated in the annual incentive plan for a number of years, with great success. The committee has decided that this success should be built upon by measuring part of the 2009 LTIP on a long-term balanced scorecard of non-financial measures underpinning the success of the integration over 2009 to 2011. These measures will be grouped under the categories by which the integration is being managed:

Risk

Customer

People

Build business

These measures are distinct from the similarly named areas under the annual incentive plan. The annual incentive measures focus on excellence of performance in business as usual activities. The non-financial measures in the integration balanced scorecard are specific to the integration. There is a major change programme to be undertaken within HBOS, particularly in relation to systems and processes for measuring and managing risk. The integration balanced scorecard will be built around outperformance on this change agenda.

PENSION

In April 2012, all executive directors will transition to defined contribution pension arrangements with contributions of 25 per cent of base salary for the group chief executive and other executive directors, with no compensation for ceasing final salary accrual.

FURTHER REVIEW OF EXECUTIVE REMUNERATION DURING 2009

The committee recognises that the above proposals for executive remuneration for 2009 are being made at a time of high uncertainty and great volatility, and therefore the committee has decided to undertake a further review of executive remuneration during 2009. This is to ensure that the overall positioning of remuneration remains appropriate when compared with the external market and ensures that the Lloyds Banking Group is able to attract and retain the high calibre of talent needed to lead the combined Group, while reflecting latest trends in the sector and any updated guidance from shareholders and regulators. The committee will continue to engage with shareholders during this review.

OTHER SHARE PLANS

The executive directors and the chairman are also eligible to participate in the Group s sharesave scheme and the Group s shareplan . These are all-employee share schemes.

CHAIRMAN S REMUNERATION

The chairman s remuneration comprises salary and benefits which are broadly similar to those extended to the executive directors. However, he does not participate in the annual bonus and long-term incentive arrangements, nor is he entitled to pension benefits.

The chairman s salary is reviewed annually, usually in December, taking into account performance and market information and then adjusted from 1 January of the following year. No adjustments will be made from 1 January 2009 and his salary remains unchanged at £640,000.

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. To accommodate a potentially larger board following the acquisition of HBOS, a resolution was passed at the general meeting on 19 November 2008 to increase this amount to £1 million. 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 from 1 January 2009 are unchanged and are listed below.

Board	£65,000
Audit committee chairmanship	£50,000
Audit committee membership	£20,000
Nomination committee membership	£5,000
Remuneration committee chairmanship	£30,000
Remuneration committee membership	£15,000
Risk oversight committee membership	£15,000

Independent non-executive directors who serve on the boards of subsidiary companies may also receive fees from the subsidiaries. The fees paid in 2008 to the current non-executive directors are shown in the table below.

COMPENSATION

REMUNERATION FOR 2008

2008 ANNUAL INCENTIVE SCHEME

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. Half of the incentive opportunity is driven by corporate performance based on the stretching budget relating to profit before tax and economic profit. The level of achievement against the targets for profit before tax and economic profit that results in the lower payout will determine the extent to which the target has been met. The other half of the incentive opportunity is determined by divisional achievement driven through individual performance. Individual targets relevant to improving overall business performance are contained in a balanced scorecard and are grouped under the following headings:

Financial

Franchise growth

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 process efficiency, service quality and employee engagement.

The maximum annual incentive opportunity is 200 per cent (225 per cent for Mr Daniels) of basic salary for the achievement of exceptional performance targets. The maximum payment under the corporate half of the annual incentive is only available if exceptional performance is achieved against the stretching corporate budget. An amount equal to 50 per cent of this element of the incentive is available on the achievement of the stretching corporate budget. Failure to achieve at least 90 per cent of the stretching budget would result in no payment under the corporate half of the incentive.

In recognition of the current environment, the executive directors have elected not to receive any annual incentive in respect of 2008.

LONG-TERM INCENTIVE PLANS

2008 LONG-TERM INCENTIVE PLAN AWARDS

In 2008, following shareholder consultation, three directors were granted enhanced awards of 375 per cent of basic salary. This was to ensure that for these directors, where there was a concern about retention, the Group continued to provide a fully market competitive remuneration framework.

Details of the plan, including the specific performance conditions, can be found on pages 99 and 100.

2008 NON-EXECUTIVE DIRECTORS FEES (£)

	Lloyds Banking Group					LTSBS*	SW**	**2008**
	Board	Audit committee	Remuneration committee	Nomination committee	Risk Oversight committee	Board	Board	**Total fees**
W C G Berndt	65,000		30,000	5,000				**100,000**
Ewan Brown	65,000	30,568			15,000	11,568		**122,136**
J P du Plessis	65,000	39,432		5,000	9,715			**119,147**
P N Green	65,000	20,000	15,000					**100,000**
Sir Julian Horn-Smith	65,000		15,000	5,000	15,000			**100,000**
Lord Leitch	65,000	20,000		5,000	15,000		60,000	**165,000**

Sir David Manning	43,333		10,000	3,333	10,000	**66,666**
C J McCall	16,250					**16,250**
M A Scicluna	21,666	6,667			5,000	**33,333**

* Lloyds TSB Scotland plc.

** Scottish Widows Services Ltd.

DILUTION LIMITS

The following charts illustrate the shares available for the Group s share schemes.

COMPENSATION

PENSIONS

Executive directors are either entitled to participate in the Group s defined benefit pension schemes (based on salary and length of service, with a maximum pension of two thirds of final salary), or the Group s defined contribution scheme (under which their pension entitlement will be based upon both employer and employee contributions). The defined benefit schemes are closed to new entrants on recruitment.

Pension accruals under the defined benefits scheme for Messrs Daniels and Kane will continue until April 2012. Thereafter they 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.

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. Executive directors normally retire at age 60. However, following the implementation of The Employment Equality (Age) Regulations 2006, they may now choose to delay their retirement until age 65.

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 Victor Blank	6 months	25 January 2006
J E Daniels	12 months	22 January 2009
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
Former directors who served during 2008		
T A Dial	12 months	23 May 2005
M E Fairey	12 months	28 August 1991

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 2008, Mr Daniels and Mrs Weir received fees of £54,718 and £42,500 respectively, which were retained by them, for serving as non-executive directors of other companies.

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.

COMPENSATION AUDITED INFORMATION

DIRECTORS EMOLUMENTS FOR 2008

	Salaries/ fees £000	Other benefits Cash £000[1]	Non-cash £000[2]	Performance-related payments £000[3]	2008 Total £000	2007 Total £000
Current directors who served during 2008						
Executive directors						
J E Daniels	**1,035**	**108**	**8**		**1,151**	2,884
A G Kane	**590**	**22**	**23**		**635**	1,377
G T Tate	**640**	**25**	**24**		**689**	1,386
T J W Tookey (from 30.10.08)	**104**	**4**			**108**	
H A Weir	**625**	**95**	**22**		**742**	1,586
Non-executive directors						
Sir Victor Blank	**640**	**12**	**17**		**669**	661
W C G Berndt	**100**				**100**	90
Ewan Brown	**122**				**122**	151
P N Green	**100**				**100**	56
Sir Julian Horn-Smith	**100**				**100**	95
Lord Leitch	**165**				**165**	130
Sir David Manning (from 01.05.08)	**67**				**67**	
C J McCall (from 01.10.08)	**16**				**16**	
M A Scicluna (from 01.09.08)	**33**				**33**	
Former directors who served during 2008						
J P du Plessis	**119**				**119**	80
M E Fairey (until 30.6.08)	**315**	**18**	**4**		**337**	1,440
T A Dial (until 18.4.08)	**340**	**128**	**2**		**470**	1,995
Others	124					
	5,111	**412**	**100**		**5,623**	12,055

Notes:

1 The cash column under other benefits includes flexible benefits payments (4 per cent of basic salary), the tax planning and education allowances for Mr Daniels, the housing allowance and pension scheme allowance for Ms Dial (paid until 30.6.08), payments to certain directors who elect to take cash rather than a company car under the car scheme and the cash balance of a pension allowance for Mrs Weir. Sir Victor Blank has elected to take cash rather than a company car.

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 Shareplan, 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 The executive directors waived their entitlement to any bonus in respect of the 2008 performance. There will be no free shares award under Shareplan in respect of 2008.

COMPENSATION AUDITED INFORMATION

WAIVED FEES

For the period 1 January 30 June 2008, Mr Fairey waived fees payable to him as a director of Lloyds TSB Group Pension Trust (No.1) Limited and Lloyds TSB Group Pension Trust (No.2) Limited, which totalled £5,000 (2007: £10,750 waived). For the period 1 July 31 December 2008, Mr Fairey received fees payable to him as a director and chairman of the Lloyds TSB Group Pension Trust (No.1) Limited and Lloyds TSB Group Pension Trust (No.2) Limited which totalled £35,000.

Mr Brown waived fees payable to him as a director and chairman of Lloyds TSB Group Pension Trust (No.1) Limited and Lloyds TSB Group Pension Trust (No.2) Limited for the period 1 January 30 June 2008, which totalled £7,000 in 2008 (2007: £15,500 waived).

DIRECTORS PENSIONS

The executive directors are currently members of one of the pension schemes provided by the Group with benefits either on a defined benefit or defined contribution basis. Those directors who joined the Group after 1 June 1989 and are members of a defined benefit scheme have pensions provided on salary in excess of the earnings cap either through membership of a funded unapproved retirement benefits scheme (FURBS) 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 pension scheme, pension will continue to accrue until 5 April 2012. 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.

Directors have a normal retirement age of 60. However, following the implementation of The Employment Equality (Age) Regulations 2006, they may now choose to delay their retirement until age 65. In the event of death in service, a lump sum of four times salary is payable plus, for members of a defined benefit scheme, a spouse s pension of two-thirds of the member s prospective pension. On death in retirement, a spouse s pension of two-thirds of the member s pension is payable. The defined benefit schemes are non-contributory. Members of defined contribution schemes are required to contribute.

DEFINED CONTRIBUTION SCHEME MEMBERS

During the year to 31 December 2008 (from 30 October 2008 for Mr Tookey), the employer has made the following (£000) contributions to the defined contribution scheme:

G T Tate	128
T J W Tookey	23
H A Weir	56

DEFINED BENEFIT SCHEME MEMBERS

	Accrued pension at 31 December 2008 £000 (a)	Accrued pension at 31 December 2007 £000 (b)	**Change in accrued pension £000 (a)-(b)**	**Transfer value at 31 December 2008 £000 (c)**	Transfer value at 31 December 2007 £000 (d)	**Change in transfer value £000 (c)-(d)**	**Additional pension earned to 31 December 2008 £000 (e)**	**Transfer value of the increase £000 (f)**
J E Daniels	**175**	147	**28**	**3,263**	2,878	**385**	**23**	**428**
A G Kane	**342**	305	**37**	**6,146**	5,701	**445**	**25**	**449**
M E Fairey	**339***	322	**17**	**n/a**	7,469	**n/a**	**n/a**	**n/a**

* Pension as at 30 June 2008 (i.e. normal retirement date).

The disclosures in columns (a) to (d) are as required by the Companies Act 1985 Schedule 7A.

Columns (a) and (b) represent the deferred pension to which the directors would have been entitled had they left the Group on 31 December 2008 and 2007, respectively.

Column (c) is the transfer value of the deferred pension in column (a) calculated as at 31 December 2008 based on factors supplied by the actuary of the relevant Group pension scheme. The basic method used to arrive at the factors has not changed during the year, although minor adjustments have been made following the introduction of new requirements applicable to transfer calculations effective from 2008.

Column (d) is the equivalent transfer value, but calculated as at 31 December 2007 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).

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 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 £1.65 million which is equivalent to an annual pension of £82,500. Any benefit in excess of this amount will incur a tax charge for the individual. 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.

FORMER DIRECTORS WHO SERVED DURING 2008

Ms Dial elected to become a member of the pension scheme for life cover only.

Mr Fairey retired as at 30 June 2008 and took his non-approved benefit entitlement in the form of a lump sum in accordance with the scheme rules. A tax free amount of £4.523 million was paid from the FURBS, with a further taxable amount of £2.446 million made by the bank from provisions set aside. The total amount of £6.969 million covered the bank s liability to provide benefits in respect of salary in excess of the earnings cap.

COMPENSATION

DIRECTORS INTERESTS

The interests, all beneficial, of those who were directors at 31 December 2008 in shares in Lloyds Banking Group were:

SHARES

	At 1 January 2008 (or later date of appointment)	**At 31 December 2008**	**At 26 February* 2009**
Executive directors			
J E Daniels	166,023	**423,018**	**607,514**
A G Kane	137,000	**204,061**	**293,523**
G T Tate	8,112	**75,072**	**108,315**
T J W Tookey	2,252	**2,493**	**4,186**
H A Weir	10,511	**61,822**	**89,306**
Non-executive directors			
Sir Victor Blank	200,000	**301,199**	**433,528**
W C G Berndt	170,000	**170,000**	**243,899**
Ewan Brown	4,677	**95,074**	**136,402**
J P du Plessis	10,000	**50,000**	**71,735**
P N Green	5,000	**5,000**	**7,173**
Sir Julian Horn-Smith	5,000	**5,000**	**7,173**
Lord Leitch	10,000	**10,000**	**14,347**
Sir David Manning	4,500	**4,500**	**6,456**
C J McCall			
M A Scicluna		**10,000**	**14,461**

* The changes in beneficial interests between 31 December 2008 and 26 February 2009 related to applications made under the 2008 placing and open offer, the scheme of arrangement relating to the acquisition of HBOS plc and partnership and matching shares acquired under the Group s employee shareplan.

COMPENSATION AUDITED INFORMATION

INTERESTS IN SHARE OPTIONS

	At 1 January 2008 (or later date of appointment)	**Granted during the year**	**Exercised during the year**	**Lapsed during the year**	**At 31 December 2008**	Exercise price	Exercise periods From	Exercise periods To	Notes
J E Daniels	939,177			**807,693**	**131,484**	419.25p	18/3/2007	17/3/2014	d, f
	521,876			**91,329**	**430,547**	474.25p	17/3/2008	16/3/2015	e, f
	2,236			**2,236**		418p	1/6/2009	30/11/2009	a, n
		6,906			**6,906**	139p	1/1/2012	30/6/2012	a, h
A G Kane	50,000			**50,000**		880p	4/3/2001	3/3/2008	b, j
	27,000				**27,000**	887.5p	4/3/2002	3/3/2009	b, g
	64,786				**64,786**	549.5p	6/3/2003	5/3/2010	c, g
	11,841				**11,841**	615.5p	8/8/2003	7/8/2010	c, g
	34,759				**34,759**	655p	6/3/2004	5/3/2011	c, g
	5,783		**5,783**			284p	1/6/2008	30/11/2008	a, k
	523,255			**450,000**	**73,255**	419.25p	18/3/2007	17/3/2014	d, f
	300,474			**52,583**	**247,891**	474.25p	17/3/2008	16/3/2015	e, f
		6,906			**6,906**	139p	1/1/2012	30/6/2012	a, h
G T Tate	268,336			**203,936**	**64,400**	419.25p	18/3/2007	17/3/2014	d, f
	195,409			**168,052**	**27,357**	403p	12/8/2007	11/8/2014	d, f
	300,474			**52,583**	**247,891**	474.25p	17/3/2008	16/3/2015	e, f
	3,851			**3,851**		418p	1/6/2011	30/11/2011	a, n
		6,906			**6,906**	139p	1/1/2012	30/6/2012	a, h
T J W Tookey	2,798			**2,798**		343p	1/6/2011	30/11/2011	a, n
		6,906			**6,906**	139p	1/1/2012	30/6/2012	a, h
H A Weir	556,208			**478,340**	**77,868**	424.75p	29/4/2007	28/4/2014	d, f
	5,093			**5,093**		321p	1/11/2009	30/4/2010	a, n
	300,474			**52,583**	**247,891**	474.25p	17/3/2008	16/3/2015	e, f
		6,906			**6,906**	139p	1/1/2012	30/6/2012	a, h
Sir Victor Blank		**4,897**		**4,897**		343p	1/6/2013	30/11/2013	a, n
		6,906			**6,906**	139p	1/1/2012	30/6/2012	a, h
Other share plan									
T J W Tookey	35,305				**35,305**	(see page 100)	20/4/2009	19/10/2009	h

COMPENSATION AUDITED INFORMATION

INTERESTS IN SHARE OPTIONS continued

	At 1 January 2008	**Granted during the year**	**Exercised during the year**	**Lapsed during the year**	**At 31 December 2008**	Exercise price	Exercise periods From	To	Notes
Former directors who served during 2008									
M E Fairey	48,000			**48,000**		859.5p	15/5/2001	14/5/2008	b, f, j
	57,000				**57,000**	817p	2/8/2002	1/8/2009	b, g
	85,896				**85,896**	549.5p	6/3/2003	5/3/2010	c, g
	10,931				**10,931**	615.5p	8/8/2003	7/8/2010	c, g
	42,884				**42,884**	655p	6/3/2004	5/3/2011	c, g
	555,992			**478,154**	**77,838**	419.25p	18/3/2007	17/3/2014	d, f
	344,754			**60,332**	**284,422**	474.25p	17/3/2008	16/3/2015	e, f
	1,789			**1,789**		418p	1/6/2009	30/11/2009	a, h
T A Dial	464,134			**464,134**	0	474p	11/8/2008	10/8/2015	e, h, m
Other share plan									
T A Dial	242,825			**242,825**		(see page 100)	1/6/2008	30/11/2008	i

Funds from this Sharesave option were repaid to Mr Fairey after he left the board.

Notes

a) Sharesave.

b) Executive option granted between March 1998 and August 1999.

c) Executive option granted between March 2000 and March 2001.

d) Executive option granted between March 2004 and August 2004.

e) Executive options granted from March 2005.

f) Exercisable to the extent at which the performance condition vested.

g) Not exercisable as the performance conditions had not been met.

h) Not exercisable as the option has not been held for the period required by the relevant scheme.

i) Option lapsed on notice of resignation tendered prior to 31 May 2008.

j) Option lapsed as not exercised by 10th anniversary of date of grant.

k) Mr Kane exercised his 2003A Sharesave option on 7 August 2008. Market price on day of exercise was 318.75p. In that regard Mr Kane made a gain of £2,009.59.

l) Exercisable Sharesave option.

m) Lapsed on resignation.

n) Cancelled Sharesave option.

Mr Fairey retired from the Group on 30 June 2008.

Mr Tookey was appointed to the board on 30 October 2008.

Ms Dial resigned from the board on 18 April 2008 and left the Group on 30 June 2008.

The market price for a share in the Company at 1 January 2008 and 31 December 2008 was 467.5p and 126p, respectively. The range of prices between 1 January 2008 and 31 December 2008 was 118.5p to 483.1229p.

None of the other directors at 31 December 2008 had options to acquire shares in the Company or its subsidiaries.

COMPENSATION AUDITED INFORMATION

The following table contains information on the performance conditions for executive options granted since 1998. The remuneration committee chose the relevant performance condition because it was felt to be challenging, aligned to shareholders interests and appropriate at the time.

Options granted		Performance conditions
March 1998	August 1999	Growth in earnings per share which is equal to the aggregate percentage change in the retail price index plus two 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.
March 2000	March 2001	As for March 1998 August 1999 except that there must have been growth in the earnings per share equal to the change in the retail price index plus three percentage points for each complete year of the relevant period.
March 2004	August 2004	That the Company s ranking based on TSR over the relevant period against a comparator group (17 UK and international financial services companies including the Company) must be at least ninth, when 14 percent of the option will be exercisable. If the Company is ranked first in the group, then 100 percent of the option will be exercisable and if ranked tenth or below the performance condition is not met. 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 Mr Tate s March option and at 14 percent for all other options granted to executive directors during 2004.
March 2005	August 2005	That the Company s ranking based on TSR over the relevant period against a comparator group (15 companies including the Company) 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. Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted to executive directors.

LLOYDS TSB PERFORMANCE SHARE PLAN

Under the plan, executive directors were required to defer 50 per cent of their bonus awards in 2005 and 2006 into shares in the Company, known as bonus shares. The number of bonus shares awarded was calculated after the deduction of income tax and national insurance from the deferred element of the bonus.

The bonus shares are held on behalf of the executive for a period of three years before release.

Executives received a further award of performance shares on the basis of two performance shares for each bonus share. The receipt of the performance shares is dependent on the satisfaction of a TSR performance condition measured over three financial years of the Company.

The following table details the number of bonus and performance shares released in respect of their 2004 bonus and the number of bonus and performance shares remaining under the plan relating to the 2005 bonus.

	Bonus shares			Performance shares					
	At 1 January 2008	Released 18 March 2008	At 31 December 2008	At 1 January 2008	Vested 10 April 2008	Lapsed 10 April 2008	At 31 December 2008	Award price	Bonus shares release date
J E Daniels	57,737	57,737		195,720	97,860	97,860		479p	18/3/2008
	50,944		50,944	172,694			172,694	566.10p	20/3/2009

A G Kane	22,171	22,171		75,156	37,578	37,578		479p	18/3/2008
	20,531		20,531	69,598			69,598	566.10p	20/3/2009
G T Tate	22,710	22,710		76,982	38,491	38,491		479p	18/3/2008
	27,358		27,358	92,738			92,738	566.10p	20/3/2009
H A Weir	16,628	16,628		56,366	28,183	28,183		479p	18/3/2008
	20,062		20,062	68,008			68,008	566.10p	20/3/2009
Former directors who served during 2008									
M E Fairey	31,901	31,901		108,140	54,070	54,070		479p	18/3/2008
	22,459*			76,134			76,134	566.10p	20/3/2009
T A Dial	16,909*		0	57,322**	N/A	N/A	0	566.10p	20/3/2009

* Bonus shares released in June 2008.

** Performance Shares lapsed on resignation.

COMPENSATION AUDITED INFORMATION

The following table contains information on the performance conditions for performance shares. The remuneration committee chose the relevant performance condition because it was felt to be challenging, aligned to shareholders interests and appropriate at the time.

Performance shares awarded	Performance conditions
March 2005 and March 2006	That the Company s ranking based on TSR over the relevant period against a comparator group (15 companies including the Company) must be at least eighth for any shares to be received. If ranked ninth or below no shares would be received. The maximum of two performance shares for each b