Chery Don J.
Form 4
December 08, 2010

# FORM 4

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

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

**STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES**

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

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(Print or Type Responses)

1. Name and Address of Reporting Person *
Chery Don J.

(Last) (First) (Middle)

49 COMMONS LOOP

(Street)

KALISPELL, MT 59901

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
GLACIER BANCORP INC [GBCI]

3. Date of Earliest Transaction (Month/Day/Year)
12/07/2010

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
EVP/CAO

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

**Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned**

| 1.Title of Security (Instr. 3) | 2. Transaction Date (Month/Day/Year) | 2A. Deemed Execution Date, if any (Month/Day/Year) | 3. Transaction Code (Instr. 8) | | 4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5) | | | 5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4) | 6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4) | 7. Nature of Indirect Beneficial Ownership (Instr. 4) |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Code | V | Amount | (A) or (D) | Price | | | |
| Common Stock | 12/07/2010 | | G | | 1,450 | D | $ 0 | 30,584 | D | |

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

**Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned**
**(*e.g.*, puts, calls, warrants, options, convertible securities)**

| 1. Title of Derivative Security (Instr. 3) | 2. Conversion or Exercise Price of Derivative Security | 3. Transaction Date (Month/Day/Year) | 3A. Deemed Execution Date, if any (Month/Day/Year) | 4. Transaction Code (Instr. 8) | | 5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5) | | 6. Date Exercisable and Expiration Date (Month/Day/Year) | | 7. Title and Amount of Underlying Securities (Instr. 3 and 4) | | 8. P Der Sec (Ins |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Code | V | (A) | (D) | Date Exercisable | Expiration Date | Title | Amount or Number of Shares | |
| Employee Stock Option | $ 20.96 | | | | | | | 01/25/2008 | 01/25/2011 | Common Stock | 7,500 | |
| Employee Stock Option | $ 23.47 | | | | | | | 01/31/2009 | 01/31/2012 | Common Stock | 5,000 | |
| Employee Stock Option | $ 18.19 | | | | | | | 01/30/2010 | 01/30/2013 | Common Stock | 6,000 | |
| Employee Stock Option | $ 15.37 | | | | | | | 01/28/2011 | 01/28/2014 | Common Stock | 4,000 | |

# Reporting Owners

| Reporting Owner Name / Address | Relationships | | | |
|---|---|---|---|---|
| | Director | 10% Owner | Officer | Other |
| Chery Don J.<br>49 COMMONS LOOP<br>KALISPELL, MT 59901 | | | EVP/CAO | |

# Signatures

| | |
|---|---|
| Don J. Chery | 12/08/2010 |
| **Signature of Reporting Person | Date |

# Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. lvetica, Sans-Serif; border-bottom: rgb(227,228,229) 1px solid; border-top: Black 1px solid">(250) – Other **654** 589 610 **758** 339 610 Restructuring costs **111** 217 124 Other staff

costs **783** 746 1,064 **5,841** 5,491 6,375 Premises and equipment: Rent and rates **467** 488 547 Hire of equipment **15** 17 22 Repairs and maintenance **178** 174 188 Other **310** 270 294 **970** 949 1,051 Other expenses: Communications and data processing **1,169** 1,082 954 Advertising and promotion **313** 314 398 Professional fees **425** 550 576 UK bank levy **238** 179 189 Other **971** 1,108 1,301 **3,116** 3,233 3,418 Depreciation and amortisation: Depreciation of tangible fixed assets (note 30) **1,374** 1,431 1,434 Amortisation of acquired value of in-force non-participating investment contracts (note 28) **54** 79 78 Amortisation of other intangible assets (note 29) **512** 616 663 **1,940** 2,126 2,175 Impairment of tangible fixed assets **–** – 65 Total operating expenses, excluding regulatory provisions **11,867** 11,799 13,084 Regulatory provisions: Payment protection insurance provision (note 43) **3,050** 3,575 – Other regulatory provisions (note 43)[3,4] **405** 600 175 **3,455** 4,175 175 **Total operating expenses** **15,322** 15,974 13,259

1 Restated – see note 1.

2 The Group has agreed certain changes to early retirement and commutation factors in two of its principal defined benefit pension schemes, resulting in a cost of £104 million recognised in the Group's income statement in the year ended 31 December 2013.

During 2012, following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change was a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in 2012, net of a charge of £8 million resulting from a change to the commutation factors in one of the Group's smaller schemes.

3 Other regulatory provisions in 2013 include a fine of £28 million levied on the Group by the Financial Conduct Authority in relation to failings in control over sales incentive schemes in the Group's branch network.

4 Regulatory provisions of £50 million were charged against income in 2012.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 11: OPERATING EXPENSES** continued

**Performance-based compensation**

The table below analyses the Group’s performance-based compensation costs (excluding branch-based sales incentives) between those relating to the current performance year and those relating to earlier years.

| | **2013 £m** | 2012 £m | 2011 £m |
|---|---|---|---|
| Performance-based compensation expense comprises: | | | |
| Awards made in respect of the year ended 31 December | **394** | 362 | 363 |
| Awards made in respect of earlier years | **79** | 33 | (2) |
| | **473** | 395 | 361 |
| Performance-based compensation expense deferred until later years comprises: | | | |
| Awards made in respect of the year ended 31 December | **47** | 37 | 43 |
| Awards made in respect of earlier years | **30** | 15 | 29 |
| | **77** | 52 | 72 |

Performance-based awards expensed in 2013 include cash awards amounting to £126 million (2012: £128 million; 2011: £160 million).

**AVERAGE HEADCOUNT**

The average number of persons on a headcount basis employed by the Group during the year was as follows:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| UK | **96,001** | 110,295 | 116,371 |
| Overseas | **1,868** | 3,322 | 4,078 |
| **Total** | **97,869** | 113,617 | 120,449 |

**FEES PAYABLE TO THE AUDITORS**

Fees payable to the Company's auditors by the Group are as follows:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Fees payable for the audit of the Company's current year annual report | **1.5** | 1.6 | 1.7 |
| Fees payable for other services: | | | |
| Audit of the Company's subsidiaries pursuant to legislation | **15.1** | 15.7 | 16.9 |
| Other services supplied pursuant to legislation | **4.4** | 4.5 | 4.8 |
| Total audit fees | **21.0** | 21.8 | 23.4 |
| Other services – audit related fees | **5.0** | 1.7 | 2.9 |
| Total audit and audit related fees | **26.0** | 23.5 | 26.3 |
| Services relating to taxation: | | | |
| Taxation compliance services | **0.3** | 0.2 | 0.2 |
| All other taxation advisory services | **0.3** | 0.6 | 0.9 |
| | **0.6** | 0.8 | 1.1 |
| Other non-audit fees: | | | |
| Services relating to corporate finance transactions | **0.3** | 0.5 | 6.3 |
| Other services | **5.6** | 2.2 | 2.6 |
| Total other non-audit fees | **5.9** | 2.7 | 8.9 |
| **Total fees payable to the Company's auditors by the Group** | **32.5** | 27.0 | 36.3 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 11: OPERATING EXPENSES** continued

The following types of services are included in the categories listed above:

**Audit fees:** This category includes fees in respect of the audit of the Group’s annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group’s Form 20-F filing.

**Audit related fees:** This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of prospectuses and circulars required by the UKLA listing rules.

**Services relating to taxation:** This category includes tax compliance and tax advisory services.

**Other non-audit fees:** This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group’s policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to the provision of advice on tax issues, assistance in transactions involving the acquisition and disposal of businesses and accounting advice.

The Group has procedures that are designed to ensure auditor independence, including that fees for audit and non-audit services are approved in advance. This approval can be obtained either on an individual engagement basis or, for certain types of non-audit services, particularly those of a recurring nature, through the approval of a fee cap covering engagements of that type provided the fee is below that cap. All statutory audit work as well as non-audit assignments where the fee is expected to exceed the relevant fee cap must be pre-approved by the Audit Committee on an individual engagement basis. On a quarterly basis, the Audit Committee receives a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

During the year, the auditors also earned fees payable by entities outside the consolidated Lloyds Banking Group in respect of the following:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Audits of Group pension schemes | **0.3** | 0.4 | 0.4 |
| Audits of the unconsolidated Open Ended Investment Companies managed by the Group | **0.5** | 0.8 | 0.6 |
| Reviews of the financial position of corporate and other borrowers | **6.5** | 5.4 | 11.0 |
| Acquisition due diligence and other work performed in respect of potential venture capital investments | **2.1** | 0.7 | 1.0 |

**NOTE 12: IMPAIRMENT**

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Impairment losses on loans and receivables: | | | |
| Loans and advances to customers | **2,725** | 5,125 | 8,020 |
| Debt securities classified as loans and receivables | **1** | (4 ) | 49 |
| Total impairment losses on loans and receivables (note 24) | **2,726** | 5,121 | 8,069 |
| Impairment of available-for-sale financial assets | **15** | 37 | 80 |
| Other credit risk provisions | **–** | (9 ) | (55 ) |
| **Total impairment charged to the income statement** | **2,741** | 5,149 | 8,094 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 13: INVESTMENTS IN JOINT VENTURES AND ASSOCIATES**

The Group's share of results of and investments in equity accounted joint ventures and associates comprises:

| | **Joint ventures** | | | **Associates** | | | **Total** | | |
|---|---|---|---|---|---|---|---|---|---|
| | **2013** | 2012 | 2011 | **2013** | 2012 | 2011 | **2013** | 2012 | 2011 |
| | **£m** | £m | £m | **£m** | £m | £m | **£m** | £m | £m |
| Share of income statement amounts: | | | | | | | | | |
| Income | **65** | 278 | 316 | **151** | 63 | 160 | **216** | 341 | 476 |
| Expenses | **(32)** | (229) | (261) | **(116)** | (68) | (161) | **(148)** | (297) | (422) |
| Impairment | **(22)** | (6) | (20) | **–** | (1) | 1 | **(22)** | (7) | (19) |
| Profit (loss) before tax | **11** | 43 | 35 | **35** | (6) | – | **46** | 37 | 35 |
| Tax | **(4)** | (9) | (4) | **1** | – | – | **(3)** | (9) | (4) |
| **Share of post-tax results** | **7** | 34 | 31 | **36** | (6) | – | **43** | 28 | 31 |
| Share of other comprehensive income | **–** | 6 | (6) | **–** | – | – | **–** | 6 | (6) |
| Share of total comprehensive income | **7** | 40 | 25 | **36** | (6) | – | **43** | 34 | 25 |
| Share of balance sheet amounts: | | | | | | | | | |
| Current assets | **519** | 3,103 | 3,346 | **115** | 127 | 246 | **634** | 3,230 | 3,592 |
| Non-current assets | **1,163** | 1,596 | 2,148 | **508** | 581 | 976 | **1,671** | 2,177 | 3,124 |
| Current liabilities | **(448)** | (729) | (714) | **(249)** | (128) | (293) | **(697)** | (857) | (1,007) |
| Non-current liabilities | **(1,139)** | (3,672) | (4,471) | **(368)** | (565) | (904) | **(1,507)** | (4,237) | (5,375) |
| **Share of net assets at 31 December** | **95** | 298 | 309 | **6** | 15 | 25 | **101** | 313 | 334 |
| Movement in investments over the year: | | | | | | | | | |
| At 1 January | **298** | 309 | 326 | **15** | 25 | 103 | **313** | 334 | 429 |
| Exchange and other adjustments | **(10)** | 2 | (3) | **–** | 1 | (1) | **(10)** | 3 | (4) |
| Additional investments | **4** | 10 | 7 | **957** | 1 | 3 | **961** | 11 | 10 |
| Disposals | **(197)** | (44) | (47) | **(983)** | (6) | (79) | **(1,180)** | (50) | (126) |
| Share of post-tax results | **7** | 34 | 31 | **36** | (6) | – | **43** | 28 | 31 |
| Dividends paid | **(7)** | (13) | (5) | **(19)** | – | (1) | **(26)** | (13) | (6) |
| **Share of net assets at 31 December** | **95** | 298 | 309 | **6** | 15 | 25 | **101** | 313 | 334 |

The Group's unrecognised share of losses of associates for the year was £4 million (2012: recognised net loss of £10 million; 2011: recognised net loss of £8 million) and of joint ventures was £94 million in 2013 (2012: £126 million; 2011: £85 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £36 million (2012: £31 million; 2011: £56 million) and of joint ventures is £358 million (2012: £330 million; 2011: £299 million).

In March 2013 the Group sold a tranche of shares in St James's Place plc, reducing the Group's holding in that company to approximately 37 per cent and from that point commenced accounting for the residual investment as an associate. The Group sold its remaining shareholding in May and December 2013 so that the entire investment had been disposed of by the end of the year.

The Group's principal joint venture investment at 31 December 2013 was in Sainsbury's Bank plc; the Group owns 50 per cent of the ordinary share capital of Sainsbury's Bank plc, whose business is banking and principal area of operation is the UK. Sainsbury's Bank plc is incorporated in the UK and the Group's interest is held by a subsidiary. In May 2013 the Group reached agreement to sell its interest in Sainsbury's Bank plc to J Sainsbury plc; this transaction completed on 31 January 2014 and the Group's investment at 31 December 2013 is included in disposal group assets (see note 16).

Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 14: TAXATION**

**(A) ANALYSIS OF TAX (CHARGE) CREDIT FOR THE YEAR**

| | 2013<br>**£m** | 2012[1]<br>£m | 2011[1]<br>£m |
|---|---|---|---|
| UK corporation tax: | | | |
| Current tax on profit for the year | (226) | (181) | (93) |
| Adjustments in respect of prior years | (205) | 58 | (146) |
| | (431) | (123) | (239) |
| Foreign tax: | | | |
| Current tax on profit for the year | (60) | (86) | (90) |
| Adjustments in respect of prior years | 26 | (8) | 36 |
| | (34) | (94) | (54) |
| Current tax (charge) credit | (465) | (217) | (293) |
| Deferred tax (note 42): | | | |
| Origination and reversal of temporary differences | (434) | (329) | 825 |
| Reduction in UK corporation tax rate | (594) | (320) | (439) |
| Adjustments in respect of prior years | 276 | 85 | (96) |
| | (752) | (564) | 290 |
| Tax charge | (1,217) | (781) | (3) |

[1] Restated – see note 1.

The charge for tax on the profit for 2013 is based on a UK corporation tax rate of 23.25 per cent (2012: 24.5 per cent; 2011: 26.5 per cent).

The income tax charge is made up as follows:

| | 2013<br>**£m** | 2012[1]<br>£m | 2011[1]<br>£m |
|---|---|---|---|
| Tax (charge) credit attributable to policyholders | (328) | (950) | 72 |
| Shareholder tax (charge) credit | (889) | 169 | (75) |
| Tax charge | (1,217) | (781) | (3) |

[1] Restated – see note 1.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 14: TAXATION** continued

**(B) FACTORS AFFECTING THE TAX (CHARGE) CREDIT FOR THE YEAR**

A reconciliation of the credit (charge) that would result from applying the standard UK corporation tax rate to the profit (loss) before tax to the actual tax (charge) credit for the year is given below:

| | 2013 **£m** | 2012[1] £m | 2011[1] £m |
|---|---|---|---|
| Profit (loss) before tax | 415 | (606) | (551) |
| Tax (charge) credit thereon at UK corporation tax rate of 23.25 per cent (2012: 24.5 per cent; 2011: 26.5 per cent) | (96) | 148 | 146 |
| Factors affecting (charge) credit: | | | |
| UK corporation tax rate change | (594) | (320) | (439) |
| Disallowed items | (167) | (186) | (121) |
| Non-taxable items | 132 | 240 | 398 |
| Overseas tax rate differences | (116) | 75 | 17 |
| Gains exempted or covered by capital losses | 57 | 36 | 106 |
| Policyholder tax | (251) | (144) | 160 |
| Further factors affecting the life business[2]: | | | |
| Derecognition of deferred tax on policyholder tax credit | – | (583) | (146) |
| Taxation of certain insurance assets arising on transition to new tax regime | – | (221) | – |
| Changes to the taxation of pension business: | | | |
| Policyholder tax cost | – | (182) | – |
| Shareholder tax benefit | – | 206 | – |
| Deferred tax on losses no longer recognised following sale of Australian operations | (348) | – | – |
| Tax losses where no deferred tax recognised | – | (25) | (261) |
| Deferred tax on Australian tax losses not previously recognised | 60 | 12 | – |
| Tax losses not previously recognised | – | – | 332 |
| Adjustments in respect of previous years | 97 | 135 | (206) |
| Effect of results of joint ventures and associates | 9 | 23 | 8 |
| Other items | – | 5 | 3 |
| Tax (charge) credit on (loss) profit on ordinary activities | (1,217) | (781) | (3) |

[1] Restated – see note 1.

[2] The Finance Act 2012 introduced a new UK tax regime for the taxation of life insurance companies which takes effect from 1 January 2013. The new regime, combined with current economic forecasts, had a number of impacts on the tax charge in 2012.

The Finance Act 2013 (the Act) was substantively enacted on 2 July 2013. The Act further reduced the main rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015. The change in the main rate of corporation tax from 23 per cent to 20 per cent has resulted in a reduction in the Group's net deferred tax asset at 31 December 2013 of £636 million, comprising the £594 million charge included in the income statement and a £42 million charge included in equity.

## NOTE 15: EARNINGS PER SHARE

| | 2013 | 2012[1] | 2011[1] |
|---|---|---|---|
| | **£m** | £m | £m |
| Loss attributable to equity shareholders – basic and diluted | (838) | (1,471) | (627) |
| | 2013 | 2012 | 2011 |
| | **million** | million | million |
| Weighted average number of ordinary shares in issue – basic | 71,009 | 69,841 | 68,470 |
| Adjustment for share options and awards | – | – | – |
| Weighted average number of ordinary shares in issue – diluted | 71,009 | 69,841 | 68,470 |
| Basic loss per share | (1.2)p | (2.1)p | (0.9)p |
| Diluted loss per share | (1.2)p | (2.1)p | (0.9)p |

[1] Restated – see note 1.

Basic earnings per share are calculated by dividing the net profit attributable to equity shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 18 million (2012: 13 million; 2011: 10 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares, if any, that arise in respect of share options and awards granted to employees. The number of shares that could have been acquired at the average annual share price of the Company's shares based on the monetary value of the subscription rights attached to outstanding share options and awards is determined. This is deducted from the number of shares issuable under such options and awards to leave a residual bonus amount of shares which are added to the weighted-average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

The weighted-average number of anti-dilutive share options and awards excluded from the calculation of diluted earnings per share was 28 million at 31 December 2013 (2012: 37 million; 2011: 619 million).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 16: DISPOSAL GROUPS**

Disposal groups are classified as held for sale if the Group will recover the carrying amount principally through a sale transaction rather than through continuing use and a sale is considered highly probable. The Group completed the sale of its joint venture interest in Sainsbury's Bank on 31 January 2014 and expects to complete the announced sales of its international private banking operations in Monaco and Gibraltar, its German insurance business and Scottish Widows Investment Partnership, its asset management business, in the next 12 months. The assets and liabilities associated with these operations are therefore classified as held-for-sale disposal groups at 31 December 2013 and included within other assets and other liabilities respectively.

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| Other assets | | |
| Assets of disposal groups classified as held for sale | 7,988 | 194 |
| | | |
| Other liabilities | | |
| Liabilities of disposal groups classified as held for sale | 7,302 | 214 |

Disposal groups classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. The Group has recognised an impairment of £382 million within other income relating to disposal groups classified as held for sale during 2013.

At 31 December 2012, the Group's Uruguayan branch business, its branch remittance business in Japan and its portfolio management business in Luxembourg were classified as held-for-sale; these sales completed in 2013.

The major classes of assets and liabilities of the disposal groups, which are principally in the Insurance segment, are as follows:

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| **Assets**[1] | | |
| Cash and balances at central banks | – | 82 |
| Trading and other financial assets at fair value through profit or loss | 5,040 | – |
| Loans and advances to banks | 101 | 7 |
| Loans and advances to customers | 244 | 84 |
| Available-for-sale financial assets | – | 27 |

| | | |
|---|---|---|
| Value of in-force business | 1,017 | – |
| Other | 1,968 | 20 |
| Provision for impairment of the disposal groups | (382 ) | (26 ) |
| | 7,988 | 194 |
| Liabilities | | |
| Customer deposits | 307 | 185 |
| Liabilities arising from insurance contracts and participating investment contracts | 4,901 | – |
| Deferred tax liabilities | 282 | – |
| Other | 1,812 | 29 |
| | 7,302 | 214 |

1 Disposal groups measured at fair value less costs to sell of £247 million (2012: liability of £20 million), which are non-recurring fair value measurements, are based on prices offered by third parties under binding sale and purchase agreements and are therefore classified within level 3 of the fair value hierarchy.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 17: TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS**

These assets are comprised as follows:

| | 2013 | | | 2012[1] | | |
|---|---|---|---|---|---|---|
| | Trading assets | Other financial assets at fair value through profit or loss | Total | Trading assets | Other financial assets at fair value through profit or loss | Total |
| | £m | £m | £m | £m | £m | £m |
| Loans and advances to customers | 21,083 | 27 | 21,110 | 13,598 | 34 | 13,632 |
| Loans and advances to banks | 8,333 | – | 8,333 | 919 | – | 919 |
| Debt securities: | | | | | | |
| Government securities | 4,259 | 16,430 | 20,689 | 3,965 | 17,380 | 21,345 |
| Other public sector securities | 14 | 2,183 | 2,197 | – | 1,056 | 1,056 |
| Bank and building society certificates of deposit | 1,491 | – | 1,491 | 3,166 | 228 | 3,394 |
| Asset-backed securities: | | | | | | |
| Mortgage-backed securities | 5 | 793 | 798 | 130 | 795 | 925 |
| Other asset-backed securities | 171 | 756 | 927 | 21 | 1,892 | 1,913 |
| Corporate and other debt securities | 1,929 | 18,691 | 20,620 | 1,172 | 26,387 | 27,559 |
| | 7,869 | 38,853 | 46,722 | 8,454 | 47,738 | 56,192 |
| Equity shares | 4 | 66,399 | 66,403 | – | 89,447 | 89,447 |
| Treasury and other bills | 61 | 54 | 115 | 374 | 56 | 430 |
| Total | 37,350 | 105,333 | 142,683 | 23,345 | 137,275 | 160,620 |

[1] Restated – see note 1.

Other financial assets at fair value through profit or loss include the following assets designated into that category:

(i) financial assets backing insurance contracts and investment contracts of £101,185 million (2012: £134,537 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise. Included within these assets are investments in unconsolidated structured entities of £24,552 million, see note 22;

(ii) loans and advances to customers of £27 million (2012: £34 million) which are economically hedged by interest rate derivatives which are not in hedge accounting relationships and where significant measurement inconsistencies would otherwise arise if the related derivatives were treated as trading liabilities and the loans and advances were carried at amortised cost; and

(iii) private equity investments of £2,632 million (2012: £2,110 million) that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2013 of the loans and advances to banks and customers designated at fair value through profit or loss was £27 million (2012: £34 million); the Group does not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk which is determined by reference to the publicly available credit ratings of the instruments involved.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £29,288 million (2012: £14,433 million). Collateral is held with a fair value of £32,434 million (2012: £19,629 million), all of which the Group is able to repledge. At 31 December 2013, £8,195 million had been repledged (2012: £15,640 million).

For amounts included above which are subject to repurchase agreements see note 54.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 18: DERIVATIVE FINANCIAL INSTRUMENTS**

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 54; and
- Derivatives held in policyholder funds as permitted by the investment strategies of those funds.

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 53.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take

place. The Group also uses credit default swaps to securitise, in combination with external funding, £828 million (2012: £2,829 million) of corporate and commercial banking loans.

Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group’s exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 18: DERIVATIVE FINANCIAL INSTRUMENTS** continued

The fair values and notional amounts of derivative instruments are set out in the following table:

| | Contract/notional amount £m | Fair value assets £m | Fair value liabilities £m |
|---|---|---|---|
| **At 31 December 2013** | | | |
| **Trading and other** | | | |
| Exchange rate contracts: | | | |
| Spot, forwards and futures | **38,213** | **699** | **639** |
| Currency swaps | **291,667** | **3,207** | **4,196** |
| Options purchased | **33,061** | **780** | **–** |
| Options written | **33,445** | **–** | **836** |
| | **396,386** | **4,686** | **5,671** |
| Interest rate contracts: | | | |
| Interest rate swaps | **1,892,322** | **15,065** | **15,388** |
| Forward rate agreements | **1,991,371** | **17** | **13** |
| Options purchased | **107,374** | **3,395** | **–** |
| Options written | **101,136** | **–** | **3,194** |
| Futures | **141,669** | **2** | **12** |
| | **4,233,872** | **18,479** | **18,607** |
| Credit derivatives | **6,507** | **208** | **190** |
| Embedded equity conversion feature | **–** | **1,212** | **–** |
| Equity and other contracts | **18,780** | **1,753** | **1,478** |
| **Total derivative assets/liabilities – trading and other** | **4,655,545** | **26,338** | **25,946** |
| **Hedging** | | | |
| Derivatives designated as fair value hedges: | | | |
| Currency swaps | **35,651** | **383** | **453** |
| Interest rate swaps | **154,657** | **4,707** | **1,044** |
| Options purchased | **522** | **10** | **–** |
| | **190,830** | **5,100** | **1,497** |
| Derivatives designated as cash flow hedges: | | | |
| Interest rate swaps | **559,690** | **1,670** | **3,017** |
| Futures | **92,692** | **5** | **–** |
| Currency swaps | **1,135** | **12** | **4** |
| | **653,517** | **1,687** | **3,021** |
| **Total derivative assets/liabilities – hedging** | **844,347** | **6,787** | **4,518** |
| **Total recognised derivative assets/liabilities** | **5,499,892** | **33,125** | **30,464** |

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 54 Credit risk.

The embedded equity conversion feature of £1,212 million (2012: £1,421 million) reflects the value of the equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009; the loss of £209 million arising from the change in fair value over 2013 (2012: gain of £249 million; 2011: loss of £5 million) is included within net gains on financial instruments held for trading within net trading income (note 7).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 18: DERIVATIVE FINANCIAL INSTRUMENTS** continued

| | Contract/notional amount £m | Fair value assets £m | Fair value liabilities £m |
|---|---|---|---|
| **At 31 December 2012**[1] | | | |
| **Trading and other** | | | |
| Exchange rate contracts: | | | |
| Spot, forwards and futures | 203,484 | 1,432 | 1,599 |
| Currency swaps | 107,217 | 1,689 | 1,683 |
| Options purchased | 42,140 | 591 | – |
| Options written | 21,757 | – | 605 |
| | 374,598 | 3,712 | 3,887 |
| Interest rate contracts: | | | |
| Interest rate swaps | 2,071,103 | 32,826 | 31,891 |
| Forward rate agreements | 1,836,186 | 494 | 593 |
| Options purchased | 105,245 | 4,463 | – |
| Options written | 115,516 | – | 4,051 |
| Futures | 53,529 | 2 | 2 |
| | 4,181,579 | 37,785 | 36,537 |
| Credit derivatives | 6,167 | 94 | 343 |
| Embedded equity conversion feature | – | 1,421 | – |
| Equity and other contracts | 23,714 | 1,974 | 1,311 |
| **Total derivative assets/liabilities – trading and other** | 4,586,058 | 44,986 | 42,078 |
| **Hedging** | | | |
| Derivatives designated as fair value hedges: | | | |
| Currency swaps | 56,188 | 817 | 356 |
| Interest rate swaps | 135,516 | 6,018 | 1,772 |
| Options written | 68 | 68 | – |
| | 191,772 | 6,903 | 2,128 |
| Derivatives designated as cash flow hedges: | | | |
| Interest rate swaps | 86,190 | 4,653 | 4,438 |
| Futures | 49,527 | 1 | – |
| Currency swaps | 2,395 | 14 | 32 |
| | 138,112 | 4,668 | 4,470 |
| **Total derivative assets/liabilities – hedging** | 329,884 | 11,571 | 6,598 |
| **Total recognised derivative assets/liabilities** | 4,915,942 | 56,557 | 48,676 |

[1] Restated – see note 1.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 18: DERIVATIVE FINANCIAL INSTRUMENTS** continued

**HEDGED CASH FLOWS**

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

| 2013 | 0-1 years £m | 1-2 years £m | 2-3 years £m | 3-4 years £m | 4-5 years £m | 5-10 years £m | 10-20 years £m | Over 20 years £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Hedged forecast cash flows expected to occur: | | | | | | | | | |
| Forecast receivable cash flows | 354 | 762 | 1,247 | 1,356 | 1,418 | 5,443 | 3,097 | 424 | 14,101 |
| Forecast payable cash flows | (46) | (41) | (57) | (75) | (75) | (429) | (503) | (143) | (1,369) |
| Hedged forecast cash flows affect profit or loss: | | | | | | | | | |
| Forecast receivable cash flows | 575 | 999 | 1,275 | 1,382 | 1,429 | 5,143 | 2,894 | 404 | 14,101 |
| Forecast payable cash flows | (51) | (48) | (63) | (70) | (75) | (432) | (491) | (139) | (1,369) |

| 2012 | 0-1 years £m | 1-2 years £m | 2-3 years £m | 3-4 years £m | 4-5 years £m | 5-10 years £m | 10-20 years £m | Over 20 years £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Hedged forecast cash flows expected to occur: | | | | | | | | | |
| Forecast receivable cash flows | 214 | 241 | 271 | 139 | 67 | 163 | 37 | 33 | 1,165 |
| Forecast payable cash flows | (168) | (126) | (36) | (40) | (148) | (960) | (1,682) | (442) | (3,602) |
| Hedged forecast cash flows affect profit or loss: | | | | | | | | | |
| Forecast receivable cash flows | 254 | 287 | 256 | 95 | 51 | 157 | 32 | 33 | 1,165 |
| Forecast payable cash flows | (190) | (120) | (41) | (42) | (154) | (963) | (1,694) | (398) | (3,602) |

There were no transactions for which cash flow hedge accounting had to be ceased in 2013 or 2012 as a result of the highly probable cash flows no longer being expected to occur.

**NOTE 19: LOANS AND ADVANCES TO BANKS**

| | 2013 | 2012[1] |
|---|---|---|
| | **£m** | £m |
| Lending to banks | 2,168 | 591 |
| Money market placements with banks | 23,197 | 32,169 |
| Total loans and advances to banks before allowance for impairment losses | 25,365 | 32,760 |
| Allowance for impairment losses (note 24) | – | (3 ) |
| Total loans and advances to banks | 25,365 | 32,757 |

[1] Restated – see note 1.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £183 million (2012: £662 million). Collateral is held with a fair value of £183 million (2012: £662 million), all of which the Group is able to repledge.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 20: LOANS AND ADVANCES TO CUSTOMERS**

| | 2013 £m | 2012 £m |
|---|---|---|
| Agriculture, forestry and fishing | 6,051 | 5,531 |
| Energy and water supply | 4,414 | 3,321 |
| Manufacturing | 7,650 | 8,530 |
| Construction | 7,024 | 7,526 |
| Transport, distribution and hotels | 22,294 | 26,568 |
| Postal and telecommunications | 2,364 | 1,397 |
| Property companies | 44,277 | 52,388 |
| Financial, business and other services | 44,807 | 49,190 |
| Personal: | | |
| Mortgages | 335,611 | 337,879 |
| Other | 23,230 | 28,334 |
| Lease financing | 4,435 | 6,477 |
| Hire purchase | 5,090 | 5,334 |
| Total loans and advances to customers before allowance for impairment losses | 507,247 | 532,475 |
| Allowance for impairment losses (note 24) | (11,966 ) | (15,250 ) |
| Total loans and advances to customers | 495,281 | 517,225 |

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £120 million (2012: £5,087 million). Collateral is held with a fair value of £112 million (2012: £4,916 million), all of which the Group is able to repledge. Included within this are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £49 million (2012: £2 million).

Loans and advances to customers include finance lease receivables, which may be analysed as follows:

| | 2013 £m | 2012 £m |
|---|---|---|
| Gross investment in finance leases, receivable: | | |
| Not later than 1 year | 557 | 1,271 |
| Later than 1 year and not later than 5 years | 1,736 | 2,049 |
| Later than 5 years | 4,542 | 6,232 |
| | 6,835 | 9,552 |
| Unearned future finance income on finance leases | (2,330) | (3,027) |
| Rentals received in advance | (70 ) | (30 ) |
| Commitments for expenditure in respect of equipment to be leased | – | (18 ) |
| Net investment in finance leases | 4,435 | 6,477 |

The net investment in finance leases represents amounts recoverable as follows:

| | 2013 | 2012 |
|---|---|---|
| | **£m** | £m |
| Not later than 1 year | 277 | 835 |
| Later than 1 year and not later than 5 years | 1,140 | 1,491 |
| Later than 5 years | 3,018 | 4,151 |
| Net investment in finance leases | 4,435 | 6,477 |

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2013 and 2012 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £6 million (2012: £33 million).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 20: LOANS AND ADVANCES TO CUSTOMERS** continued

The unguaranteed residual values included in finance lease receivables were as follows:

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Not later than 1 year | 31 | 49 |
| Later than 1 year and not later than 5 years | 20 | 126 |
| Later than 5 years | – | 14 |
| **Total unguaranteed residual values** | 51 | 189 |

**NOTE 21: SECURITISATIONS AND COVERED BONDS**

**SECURITISATION PROGRAMMES**

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the structured entities described below, the Group sponsors three conduit programmes, Argento, Cancara and Grampian.

**COVERED BOND PROGRAMMES**

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 35.

| | **2013 Loans and advances securitised £m** | **Notes in issue £m** | 2012 Loans and advances securitised £m | Notes in issue £m |
|---|---|---|---|---|
| **Securitisation programmes**[1] | | | | |
| UK residential mortgages | **55,998** | **36,286** | 80,125 | 57,285 |
| US residential mortgage-backed securities | **–** | **–** | 185 | 221 |
| Commercial loans | **10,931** | **11,259** | 15,024 | 14,110 |
| Irish residential mortgages | **–** | **–** | 5,189 | 3,509 |
| Credit card receivables | **6,314** | **3,992** | 6,974 | 3,794 |
| Dutch residential mortgages | **4,381** | **4,508** | 4,547 | 4,682 |
| Personal loans | **2,729** | **750** | 4,412 | 2,000 |
| PFI/PPP and project finance loans | **525** | **106** | 688 | 104 |
| Motor vehicle loans | **–** | **–** | 1,039 | 1,086 |
| | **80,878** | **56,901** | 118,183 | 86,791 |
| Less held by the Group | | **(38,288)** | | (58,732) |
| **Total securitisation programmes (note 35)** | | **18,613** | | 28,059 |
| **Covered bond programmes** | | | | |
| Residential mortgage-backed | **59,576** | **36,473** | 91,420 | 64,593 |
| Social housing loan-backed | **2,536** | **1,800** | 2,927 | 2,400 |
| | **62,112** | **38,273** | 94,347 | 66,993 |
| Less held by the Group | | **(7,606)** | | (26,320) |
| **Total covered bond programmes (note 35)** | | **30,667** | | 40,673 |
| **Total securitisation and covered bond programmes** | | **49,280** | | 68,732 |

[1] Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £13,500 million (2012: £19,691 million) held by the Group are restricted in use to repayment of the debt securities issued by the structured entities, the term advances relating to covered bonds and other legal obligations. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2013 these obligations had not been triggered and the maximum exposure under these facilities was £402 million (2012: £497 million).

The Group has a number of covered bond programmes, for which Limited Liability Partnerships have been established to ring-fence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had over-collateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 21: SECURITISATIONS AND COVERED BONDS** continued

time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cashflows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not voluntarily offered to repurchase assets from any of its public securitisation programmes during 2013 (2012: £471 million was voluntarily repurchased). Such repurchases are made in order to ensure that the expected maturity dates of the notes issued from these programmes are met.

## NOTE 22: STRUCTURED ENTITIES

The Group’s interests in structured entities are both consolidated and unconsolidated. Detail of the Group’s interests in consolidated structured entities are set out in: note 21 for securitisations and covered bond vehicles, note 41 for structured entities associated with the Group’s pension schemes, and below in part (A) and (B). Details of the Group’s interests in unconsolidated structured entities are included below in part (C).

### (A) ASSET-BACKED CONDUITS

In addition to the structured entities discussed in note 21, which are used for securitisation and covered bond programmes, the Group sponsors three asset-backed conduits, Argento, Cancara and Grampian, which invest in debt securities and client receivables. All the external assets in these conduits are consolidated in the Group’s financial statements. The total consolidated exposures in these conduits are set out in the table below:

| | Argento £m | Cancara £m | Grampian £m | Total £m |
|---|---|---|---|---|
| At 31 December 2013 | | | | |
| Loans and advances | 161 | 4,781 | 9 | 4,951 |
| Debt securities classified as loans and receivables: | | | | |
| Asset-backed securities | 299 | 300 | – | 599 |
| Debt securities classified as available-for-sale financial assets: | | | | |
| Asset-backed securities | 356 | – | – | 356 |
| Total assets | 816 | 5,081 | 9 | 5,906 |
| At 31 December 2012 | | | | |
| Loans and advances | 140 | 4,342 | 58 | 4,540 |
| Debt securities classified as loans and receivables: | | | | |
| Asset-backed securities | 603 | 367 | 358 | 1,328 |
| Debt securities classified as available-for-sale financial assets: | | | | |
| Asset-backed securities | 396 | – | 143 | 539 |
| Total assets | 1,139 | 4,709 | 559 | 6,407 |

All debt securities and lending assets held by the Group in Cancara are restricted in use, as they are held by the collateral agent for the benefit of the commercial paper investors and the liquidity providers only. The Group provides liquidity facilities to Cancara under terms that are usual and customary for standard lending activities in the normal course of the Group's banking activities. The Group could be asked to provide support under the contractual terms of these arrangements if Cancara experienced a shortfall in external funding, which may occur in the event of market disruption. As at 31 December 2013 and 2012 these obligations had not been triggered.

Argento and Grampian have no Commercial Paper in issue and no external liquidity providers. Any restriction on the use of the assets included in the table above by the Group is due to their use in repurchase transactions see note 20 and note 53.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 22: STRUCTURED ENTITIES** continued

**(B) CONSOLIDATED COLLECTIVE INVESTMENT VEHICLES**

The assets and liabilities of the Insurance business held in consolidated collective investment vehicles, such as Open-Ended Investment Companies and limited partnerships, are not directly available for use by the Group. However, the Group's investment in the majority of these collective investment vehicles is readily realisable. As at 31 December 2013, the total carrying value of these consolidated collective investment vehicle assets and liabilities held by the Group was £55,934 million (2012: £68,644 million).

The Group has no contractual arrangements (such as liquidity facilities) that would require it to provide financial or other support to the consolidated collective investment vehicles; the Group has not previously provided such support and has no current intentions to provide such support.

**(C) UNCONSOLIDATED COLLECTIVE INVESTMENT VEHICLES AND LIMITED PARTNERSHIPS**

The Group's direct interests in unconsolidated structured entities comprise investments in collective investment vehicles, such as Open-Ended Investment Companies and limited partnerships with a total carrying value of £24,552 million at 31 December 2013, included within financial assets designated at fair value through profit and loss (see note 17). At 31 December 2013, the total asset value of these unconsolidated structured entities, including the portion in which the Group has no interest, was £543 billion.

The Group's maximum exposure to loss is equal to the carrying value of the investment. However, the Group's investments in collective investment vehicles are primarily held to match policyholder liabilities in the Insurance division and the majority of the risk from a change in the value of the Group's investment is matched by a change in policyholder liabilities. The collective investment vehicles are primarily financed by investments from investors in the vehicles.

During the year the Group has not provided any non-contractual financial or other support to these unconsolidated collective investment vehicles.

The Group considers itself the sponsor of a structured entity where it is primarily involved in the design and establishment of the structured entity; and further where the Group transfers assets to the structured entity; market products associated with the structured entity in its own name and/or provide guarantees regarding the structured entity's performance.

The Group's asset management businesses sponsor a range of diverse investment funds and limited partnerships where it acts as the fund manager or equivalent decision maker and markets the funds under one of the Group's brands.

The Group earns fees from managing the investments of these funds. The investment management fees that the Group earned from unconsolidated collective investment vehicles, including those in which the Group held no interest at 31 December 2013, are reported in note 51.

**NOTE 23: DEBT SECURITIES CLASSIFIED AS LOANS AND RECEIVABLES**

Debt securities accounted for as loans and receivables comprise:

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| Asset-backed securities: | | |
| Mortgage-backed securities | 333 | 3,927 |
| Other asset-backed securities | 740 | 1,150 |
| Corporate and other debt securities | 407 | 402 |
| Total debt securities classified as loans and receivables before allowance for impairment losses | 1,480 | 5,479 |
| Allowance for impairment losses (note 24) | (125 ) | (206 ) |
| Total debt securities classified as loans and receivables | 1,355 | 5,273 |

For amounts included above which are subject to repurchase agreements see note 54.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 24: ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES**

| | Loans and advances to customers £m | Loans and advances to banks £m | Debt securities £m | Total £m |
|---|---|---|---|---|
| At 1 January 2012 | 18,732 | 14 | 276 | 19,022 |
| Exchange and other adjustments | (379) | (1) | (8) | (388) |
| Advances written off | (8,697) | (10) | (73) | (8,780) |
| Recoveries of advances written off in previous years | 843 | – | 15 | 858 |
| Unwinding of discount | (374) | – | – | (374) |
| Charge (release) to the income statement (note 12) | 5,125 | – | (4) | 5,121 |
| At 31 December 2012 | 15,250 | 3 | 206 | 15,459 |
| Exchange and other adjustments | 291 | – | – | 291 |
| Disposal of businesses | (176) | – | – | (176) |
| Advances written off | (6,229) | (3) | (82) | (6,314) |
| Recoveries of advances written off in previous years | 456 | – | – | 456 |
| Unwinding of discount | (351) | – | – | (351) |
| Charge to the income statement (note 12) | 2,725 | – | 1 | 2,726 |
| At 31 December 2013 | 11,966 | – | 125 | 12,091 |

Of the total allowance in respect of loans and advances to customers, £10,217 million (2012: £13,936 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £2,217 million (2012: £3,309 million) was assessed on a collective basis.

**NOTE 25: AVAILABLE-FOR-SALE FINANCIAL ASSETS**

| | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Conduits £m | Other £m | Total £m | Conduits £m | Other £m | Total £m |
| Debt securities: | | | | | | |
| Government securities | – | 38,290 | 38,290 | – | 25,555 | 25,555 |
| Bank and building society certificates of deposit | – | 208 | 208 | – | 188 | 188 |
| Asset-backed securities: | | | | | | |
| Mortgage-backed securities | 139 | 1,124 | 1,263 | 277 | 1,247 | 1,524 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Other asset-backed securities | 217 | 698 | 915 | 262 | 498 | 760 |
| Corporate and other debt securities | – | 1,855 | 1,855 | – | 1,848 | 1,848 |
| | 356 | 42,175 | 42,531 | 539 | 29,336 | 29,875 |
| Equity shares | – | 570 | 570 | – | 528 | 528 |
| Treasury and other bills | – | 875 | 875 | – | 971 | 971 |
| Total available-for-sale financial assets | 356 | 43,620 | 43,976 | 539 | 30,835 | 31,374 |

Details of the Group’s asset-backed conduits shown in the table above are included in note 22.

For amounts included above which are subject to repurchase agreements see note 54.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2(H).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 26: INVESTMENT PROPERTIES**

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| At 1 January | 5,405 | 6,122 |
| Exchange and other adjustments | 11 | 22 |
| Additions: | | |
| Acquisitions of new properties | 270 | 428 |
| Consolidation of new subsidiary undertakings | 805 | 411 |
| Additional expenditure on existing properties | 39 | 89 |
| Total additions | 1,114 | 928 |
| Disposals | (1,240) | (1,403) |
| Changes in fair value (note 7) | 156 | (264) |
| Disposal of businesses | (582) | – |
| At 31 December | 4,864 | 5,405 |

In addition, the following amounts have been recognised in the income statement:

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Rental income (note 9) | 308 | 389 |
| Direct operating expenses arising from investment properties that generate rental income | 59 | 42 |

Capital expenditure in respect of investment properties:

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements | 2 | 24 |

The investment properties are valued at least annually at open-market value, by independent professionally qualified valuers, who have recent experience in the location and categories of the investment properties being valued.

The fair value of investment properties is measured using the market approach and incorporates the income approach where appropriate. The fair value of investment property is generally measured using observable inputs. Whether investment properties are categorised as level 2 or 3 (see note 53 (4) for details of levels in the fair value hierarchy) depends on the extent of the adjustments made to observable inputs and this depends on the investment property concerned. Investment property is compared to property for which there is observable market data about its realisable value on disposal. Adjustments to this observable data are applied, if necessary, for specific characteristics of the property, such as the nature, location or condition of the specific asset. If such information is not available, alternative valuation methods using unobservable inputs, such as discounted cash flow analysis or recent prices in less active markets are used. For investment property under construction, the value on disposal is considered to be at the point at which the property is fully constructed. Adjustments are made for the costs and risks associated with construction. Investment property under construction for which fair value is not yet reliably measurable is valued at cost, until the fair value can be reliably measured.

The table above analyses movements in investment properties, all of which are categorised as level 3.

**NOTE 27: GOODWILL**

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| At 1 January and 31 December | 2,016 | 2,016 |
| Cost[1] | 2,362 | 2,362 |
| Accumulated impairment losses | (346 ) | (346 ) |
| At 31 December | 2,016 | 2,016 |

1 For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (2012: £2,016 million), £1,836 million, or 91 per cent of the total (2012: £1,836 million, 91 per cent of the total) has been allocated to Scottish Widows in the Group's Insurance division and £170 million, or 8 per cent of the total (2012: £170 million, 8 per cent of the total) to Asset Finance in the Group's Wealth, Asset Finance and International division.

The recoverable amount of Scottish Widows has been based on a value-in-use calculation. The calculation uses pre-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 12 per cent. The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 27: GOODWILL** continued

The recoverable amount of Asset Finance has also been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent. The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Asset Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Asset Finance to fall below the balance sheet carrying value.

**NOTE 28: VALUE OF IN-FORCE BUSINESS**

The gross value of in-force business asset in the consolidated balance sheet is as follows:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| Acquired value of in-force non-participating investment contracts | **461** | 1,312 |
| Value of in-force insurance and participating investment contracts | **4,874** | 5,488 |
| **Total value of in-force business** | **5,335** | 6,800 |

The movement in the acquired value of in-force non-participating investment contracts over the year is as follows:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **1,312** | 1,391 |
| Amortisation taken to income statement (note 11) | **(54 )** | (79 ) |
| Disposal of businesses | **(797 )** | – |
| **At 31 December** | **461** | 1,312 |

The acquired value of in-force non-participating investment contracts includes £277 million (2012: £303 million) in relation to OEIC business.

The movement in the value of in-force insurance and participating investment contracts over the year is as follows:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **5,488** | 5,247 |
| Exchange and other adjustments | **21** | (28 ) |
| Movements in the year: | | |
| New business | **595** | 570 |
| Existing business: | | |
| Expected return | **(432 )** | (471 ) |
| Experience variances | **(246 )** | 52 |
| Assumption changes | **37** | (90 ) |
| Economic variance | **462** | 208 |
| Movement in the value of in-force business taken to income statement (note 9) | **416** | 269 |
| Disposal of businesses | **(1,051 )** | – |
| **At 31 December** | **4,874** | 5,488 |

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value the liabilities, of the relevant businesses. The presentation of economic variance includes the impact of financial market conditions being different at the end of the reporting period from those included in assumptions used to calculate new and existing business returns.

The principal features of the methodology and process used for determining key assumptions used in the calculation of the value of in-force business are set out below:

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 28: VALUE OF IN-FORCE BUSINESS** continued

**ECONOMIC ASSUMPTIONS**

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn a risk-free rate and all cash flows are discounted at a risk-free rate. The certainty equivalent approach covers all investment assets relating to insurance and participating investment contracts, other than the annuity business (where an illiquidity premium is included, see below).

A market-consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date. Further information on options and guarantees can be found on page 129.

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds and, since late 2012, illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. The determination of the market premium for illiquidity reflects actual asset allocation and relevant observable market data, and has been checked for consistency with the capital markets. The illiquidity premium is estimated to be 91 basis points at 31 December 2013 (2012: 73 basis points). Moving to the actual asset return in the calculation of the market premium for illiquidity combined with a change to the assumed level of illiquidity within the illiquid loan assets, has been to increase the value of in-force business by £118 million at 31 December 2013. This is included as an assumption change in the table above. The effect of this change on profit before tax, after also including the impacts of movements in liabilities, is given in note 36.

The risk-free rate is derived from the relevant swap curve less a deduction for credit risk. Prior to 2013, the risk-free rate for the valuation of financial options and guarantees was defined as the spot yield derived from the relevant government bond yield curve. The risk-free rate for the non-annuity business was defined as the 15 year government bond. For the annuity business, the risk-free rate was based on the UK Government bond yield curve (plus an allowance for an illiquidity premium).

The effect of deriving risk-free rates from swap curves instead of government bond yields has been to increase the value of in-force business by £132 million at 31 December 2013. This is included as an assumption change in the table above. The effect of this change on profit before tax, also after including the impacts of movements in liabilities, is given in note 36.

The table below shows the resulting range of yields and other key assumptions at 31 December for UK business:

| | 2013[1] % | 2012 % |
|---|---|---|
| Risk-free rate (value of in-force non-annuity business) | **0.00 to 4.04** | 2.32 |
| Risk-free rate (value of in-force annuity business) | **0.64 to 5.06** | 3.25 |
| Risk-free rate (financial options and guarantees) | **0.21 to 3.45** | 0.22 to 3.56 |
| Retail price inflation | 3.59 | 3.13 |
| Expense inflation | 4.25 | 3.61 |

[1] All risk-free rates at 31 December 2013 are quoted as the range of rates implied by the relevant swap curve.

**NON-MARKET RISK**

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit funds these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

**NON-ECONOMIC ASSUMPTIONS**

Future mortality, morbidity, expenses, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management’s view of future experience.

**MORTALITY AND MORBIDITY**

The mortality and morbidity assumptions, including allowances for improvements in longevity, are set with regard to the Group’s actual experience where this provides a reliable basis and relevant industry data otherwise. For German business, appropriate industry tables have been considered.

**LAPSE (PERSISTENCY) AND PAID-UP RATES**

Lapse and paid up rates assumptions are reviewed each year. The most recent experience is considered along with the results of previous analyses and management's views on future experience. In determining this best estimate view, a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration and any known or expected trends in underlying data. The pensions lapse assumptions have been strengthened due to persistency experience and to make allowance for the impact of the Office of Fair Trading review on fairness of legacy pension charges. The impact of these changes has been to decrease the value of in-force business by £158 million.

**MAINTENANCE EXPENSES**

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

These assumptions are intended to represent a best estimate of future experience, and further information about the effect of changes in key assumptions is given in note 37.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 29: OTHER INTANGIBLE ASSETS**

| | Brands £m | Core deposit intangible £m | Purchased credit card relationships £m | Customer-related intangibles £m | Capitalised software enhancements £m | Total £m |
|---|---|---|---|---|---|---|
| Cost: | | | | | | |
| At 1 January 2012 | 596 | 2,770 | 300 | 881 | 959 | 5,506 |
| Exchange and other adjustments | – | – | – | – | 27 | 27 |
| Additions | – | – | – | – | 236 | 236 |
| Disposals | – | – | – | – | (89) | (89) |
| At 31 December 2012 | 596 | 2,770 | 300 | 881 | 1,133 | 5,680 |
| Exchange and other adjustments | – | – | – | – | 22 | 22 |
| Additions | – | – | 15 | – | 274 | 289 |
| Disposals | – | – | – | – | (92) | (92) |
| Disposal of businesses | – | – | – | (343) | (17) | (360) |
| At 31 December 2013 | 596 | 2,770 | 315 | 538 | 1,320 | 5,539 |
| Accumulated amortisation: | | | | | | |
| At 1 January 2012 | 65 | 1,192 | 178 | 486 | 389 | 2,310 |
| Exchange and other adjustments | – | – | – | – | 25 | 25 |
| Charge for the year | 21 | 368 | 60 | 40 | 127 | 616 |
| Disposals | – | – | – | – | (63) | (63) |
| At 31 December 2012 | 86 | 1,560 | 238 | 526 | 478 | 2,888 |
| Exchange and other adjustments | – | – | – | – | 9 | 9 |
| Charge for the year | 21 | 300 | 62 | 20 | 109 | 512 |
| Disposals | – | – | – | – | (45) | (45) |
| Disposal of businesses | – | – | – | (104) | – | (104) |
| At 31 December 2013 | 107 | 1,860 | 300 | 442 | 551 | 3,260 |
| Balance sheet amount at 31 December 2013 | 489 | 910 | 15 | 96 | 769 | 2,279 |
| Balance sheet amount at 31 December 2012 | 510 | 1,210 | 62 | 355 | 655 | 2,792 |

Included within brands above are assets of £380 million (31 December 2012: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not have an indefinite useful life.

The core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates, and the balance sheet amount at 31 December 2013 shown above will be amortised, in accordance with the Group's accounting policy, on a straight line basis over its remaining useful life of four years.

The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income.

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 30: TANGIBLE FIXED ASSETS**

| | Premises £m | Equipment £m | Operating lease assets £m | Total tangible fixed assets £m |
|---|---|---|---|---|
| Cost: | | | | |
| At 1 January 2012 | 2,454 | 4,792 | 5,519 | 12,765 |
| Exchange and other adjustments | 2 | (82) | (11) | (91) |
| Additions | 225 | 711 | 1,314 | 2,250 |
| Disposals | (65) | (306) | (1,924) | (2,295) |
| Write-offs | – | (1,562) | – | (1,562) |
| At 31 December 2012 | 2,616 | 3,553 | 4,898 | 11,067 |
| Exchange and other adjustments | – | 83 | (17) | 66 |
| Additions | 300 | 758 | 1,326 | 2,384 |
| Disposals | (48) | (406) | (1,460) | (1,914) |
| Disposal of businesses | (2) | (94) | (80) | (176) |
| At 31 December 2013 | 2,866 | 3,894 | 4,667 | 11,427 |
| Accumulated depreciation and impairment: | | | | |
| At 1 January 2012 | 1,097 | 2,983 | 1,012 | 5,092 |
| Exchange and other adjustments | (8) | (77) | 52 | (33) |
| Depreciation charge for the year | 130 | 432 | 869 | 1,431 |
| Disposals | (28) | (266) | (909) | (1,203) |
| Write-offs | – | (1,562) | – | (1,562) |
| At 31 December 2012 | 1,191 | 1,510 | 1,024 | 3,725 |
| Exchange and other adjustments | 4 | 18 | (10) | 12 |
| Depreciation charge for the year | 145 | 418 | 811 | 1,374 |
| Disposals | (41) | (305) | (808) | (1,154) |
| Disposal of businesses | – | (68) | (32) | (100) |
| At 31 December 2013 | 1,299 | 1,573 | 985 | 3,857 |
| Balance sheet amount at 31 December 2013 | 1,567 | 2,321 | 3,682 | 7,570 |
| Balance sheet amount at 31 December 2012 | 1,425 | 2,043 | 3,874 | 7,342 |

At 31 December the future minimum rentals receivable under non-cancellable operating leases were as follows:

| | **2013 £m** | 2012 £m |
|---|---|---|
| Receivable within 1 year | **1,053** | 1,039 |
| 1 to 5 years | **1,165** | 1,291 |
| Over 5 years | **356** | 435 |
| **Total future minimum rentals receivable** | **2,574** | 2,765 |

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2013 and 2012 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £19 million at 31 December 2013 (£30 million at 31 December 2012) is expected to be received under non-cancellable sub-leases of the Group’s premises.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 31: OTHER ASSETS**

| | 2013 £m | 2012[1] £m |
|---|---|---|
| Assets arising from reinsurance contracts held (note 36 and note 38) | 732 | 2,320 |
| Deferred acquisition and origination costs (see below) | 130 | 774 |
| Settlement balances | 2,904 | 1,332 |
| Corporate pension asset | 9,984 | 6,353 |
| Investments in joint ventures and associates (note 13) | 101 | 313 |
| Assets of disposal groups (note 16) | 7,988 | 194 |
| Other assets and prepayments | 5,187 | 7,212 |
| Total other assets | 27,026 | 18,498 |

[1] Restated – see note 1.

Deferred acquisition and origination costs:

| | 2013 £m | 2012 £m |
|---|---|---|
| At 1 January | 774 | 693 |
| Costs deferred, net of amounts amortised to the income statement | (19 ) | 80 |
| Exchange and other adjustments | – | 1 |
| Disposal of businesses | (625) | – |
| At 31 December | 130 | 774 |

**NOTE 32: DEPOSITS FROM BANKS**

| | 2013 £m | 2012 £m |
|---|---|---|
| Liabilities in respect of securities sold under repurchase agreements | 1,874 | 23,368 |
| Other deposits from banks | 12,108 | 15,037 |
| Deposits from banks | 13,982 | 38,405 |

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £1,874 million (2012: £23,078 million) and a fair value of £2,112 million (2012: £25,682 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £nil (2012: £4 million).

**NOTE 33: CUSTOMER DEPOSITS**

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Non-interest bearing current accounts | 40,802 | 36,909 |
| Interest bearing current accounts | 77,789 | 65,202 |
| Savings and investment accounts | 265,422 | 261,573 |
| Liabilities in respect of securities sold under repurchase agreements | 2,978 | 4,433 |
| Other customer deposits | 54,320 | 58,795 |
| Customer deposits | 441,311 | 426,912 |

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £2,978 million (2012: £4,429 million) and a fair value of £3,114 million (2012: £4,552 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £416 million (2012: £192 million).

Included in the amounts reported above are deposits of £258,384 million (2012: £246,965 million) which are protected under the UK Financial Services Compensation Scheme.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 34: TRADING AND OTHER FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS**

| | 2013 £m | 2012[1] £m |
|---|---|---|
| Liabilities held at fair value through profit or loss | 5,306 | 5,700 |
| Trading liabilities: | | |
| Liabilities in respect of securities sold under repurchase agreements | 28,902 | 24,553 |
| Short positions in securities | 6,890 | 2,200 |
| Other | 2,527 | 939 |
| | 38,319 | 27,692 |
| Trading and other financial liabilities at fair value through profit or loss | 43,625 | 33,392 |

[1] Restated – see note 1.

Liabilities designated at fair value through profit or loss primarily represent debt securities in issue which either contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities, or which are accounted for at fair value to significantly reduce an accounting mismatch.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2013 was £6,625 million, which was £1,358 million higher than the balance sheet carrying value (2012: £6,553 million, which was £853 million higher than the balance sheet carrying value). At 31 December 2013 there was a cumulative £214 million increase in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds Bank plc, the issuing entity within the Group. Of the cumulative amount a decrease of £40 million arose in 2013 and an increase of £437 million arose in 2012.

**NOTE 35: DEBT SECURITIES IN ISSUE**

| | 2013 £m | 2012[1] £m |
|---|---|---|
| Medium-term notes issued | 23,921 | 29,537 |
| Covered bonds (note 21) | 30,667 | 40,673 |
| Certificates of deposit issued | 8,866 | 11,087 |
| Securitisation notes (note 21) | 18,613 | 28,059 |
| Commercial paper | 5,035 | 7,897 |

| | | |
|---|---|---|
| Total debt securities in issue | 87,102 | 117,253 |

[1] Restated – see note 1.

**NOTE 36: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS**

Insurance contract and participating investment contract liabilities are comprised as follows:

| | 2013 Gross £m | **Reinsurance[1] £m** | Net £m | 2012 Gross £m | Reinsurance[1] £m | Net £m |
|---|---|---|---|---|---|---|
| Life insurance (see (1) below): | | | | | | |
| Insurance contracts | 67,626 | (675) | 66,951 | 65,650 | (2,257) | 63,393 |
| Participating investment contracts | 14,416 | – | 14,416 | 16,489 | – | 16,489 |
| | 82,042 | (675) | 81,367 | 82,139 | (2,257) | 79,882 |
| Non-life insurance contracts (see (2) below): | | | | | | |
| Unearned premiums | 442 | (10) | 432 | 494 | (16) | 478 |
| Claims outstanding | 293 | – | 293 | 320 | (1) | 319 |
| | 735 | (10) | 725 | 814 | (17) | 797 |
| Total | 82,777 | (685) | 82,092 | 82,953 | (2,274) | 80,679 |

[1] Reinsurance balances are reported within other assets (note 31).

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**NOTE 36: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS** continued

**(1) LIFE INSURANCE**

The movement in life insurance contract and participating investment contract liabilities over the year can be analysed as follows:

| | **Insurance contracts £m** | Participating investment contracts £m | **Gross £m** | **Reinsurance £m** | **Net £m** |
|---|---|---|---|---|---|
| At 1 January 2012 | 62,399 | 15,631 | 78,030 | (2,452) | 75,578 |
| New business | 2,757 | 65 | 2,822 | (67) | 2,755 |
| Changes in existing business | 668 | 794 | 1,462 | 253 | 1,715 |
| Change in liabilities charged to the income statement (note 10) | 3,425 | 859 | 4,284 | 186 | 4,470 |
| Exchange and other adjustments | (174) | (1) | (175) | 9 | (166) |
| At 31 December 2012 | 65,650 | 16,489 | 82,139 | (2,257) | 79,882 |
| New business | 4,008 | 295 | 4,303 | (28) | 4,275 |
| Changes in existing business | 3,230 | (2,349) | 881 | 76 | 957 |
| Change in liabilities charged to the income statement (note 10) | 7,238 | (2,054) | 5,184 | 48 | 5,232 |
| Exchange and other adjustments | (2) | (11) | (13) | (7) | (20) |
| Disposal of businesses | (5,260) | (8) | (5,268) | 1,541 | (3,727) |
| At 31 December 2013 | 67,626 | 14,416 | 82,042 | (675) | 81,367 |

Liabilities for insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the PRA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

| | **2013** | | | 2012 | | |
|---|---|---|---|---|---|---|
| | **With-profit fund £m** | **Non-profit fund £m** | **Total £m** | With-profit fund £m | Non-profit fund £m | Total £m |
| Insurance contracts | 11,739 | 55,887 | 67,626 | 12,383 | 53,267 | 65,650 |
| Participating investment contracts | 9,227 | 5,189 | 14,416 | 9,646 | 6,843 | 16,489 |
| Total | 20,966 | 61,076 | 82,042 | 22,029 | 60,110 | 82,139 |

**WITH-PROFIT FUND REALISTIC LIABILITIES**

(I) BUSINESS DESCRIPTION

The Group has with-profit funds within Scottish Widows plc and Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

(II) METHOD OF CALCULATION OF LIABILITIES

With-profit liabilities are stated at their realistic value, the main components of which are:

–With-profit benefit reserve, the total asset shares for with-profit policies;
–Cost of options and guarantees (including guaranteed annuity options);
–Deductions levied against asset shares;
–Planned enhancements to with-profits benefits reserve; and
–Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market-consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 28.

(III) ASSUMPTIONS

Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

*Investment returns and discount rates*

The realistic capital regime dictates that with-profit fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free

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**NOTE 36: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS** continued

yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant swap curve, adjusted for credit risk. Further information on significant options and guarantees is given on page 129.

*Guaranteed annuity option take-up rates*

Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options, key assumptions in determining the cost of options are economic conditions in which the option has value, mortality rates and take up rates of other options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

*Investment volatility*

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

*Mortality*

The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group’s actual experience where this is significant, and relevant industry data otherwise.

*Lapse rates (persistency)*

Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistency experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistency will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

**NON-PROFIT FUND LIABILITIES**

(I) BUSINESS DESCRIPTION

The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types of business arise from management fees and other policy charges.

*Unit-linked business* – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

*Life insurance* – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole of life and term assurance and long-term creditor policies.

*Annuities* – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

German insurance business is written through the Group's subsidiary Heidelberger Leben and comprises policies similar to the UK definitions above, except that there is participation by the policyholder in the investment, insurance and expense profits of Heidelberger Leben. A minimum level of policyholder participation is prescribed by German law. The following types of life insurance contracts are written:

–Traditional and unit linked endowment or pensions business; and

–Life insurance business.

In August 2013 the Group announced the sale of Heidelberger Leben, which is expected to complete in the first quarter of 2014.

(II) METHOD OF CALCULATION OF LIABILITIES

The non-profit fund liabilities are determined on the basis of recognised actuarial methods and consistent with the approach required by regulatory rules. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

(III) ASSUMPTIONS

Generally, assumptions used to value non-profit fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of non-profit fund liabilities are:

*Interest rates*

The rates used are derived in accordance with the guidelines set by local regulatory bodies. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the guidelines set by local regulatory bodies, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 36: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS** continued

*Mortality and morbidity*

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation. For German business appropriate industry tables have been considered.

*Lapse rates (persistency)*

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

*Maintenance expenses*

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

*Key changes in assumptions*

A detailed review of the Group's assumptions in 2013 resulted in the following key impacts on profit before tax:

- Change in persistency assumptions (£210 million decrease).
- Change in the assumption in respect of current and future mortality rates (£114 million increase).
- Change in expenses assumptions (£34 million increase).
- Move to swap curves to derive risk-free rates (£174 million increase).
- Determination of illiquidity premium for annuity business based on actual asset allocation and change to assumed level of illiquidity within illiquid loan assets (£118 million increase).

These amounts include the impacts of movements in liabilities and value of the in-force business in respect of insurance contracts and participating investment contracts.

**(2) NON-LIFE INSURANCE**

Gross non-life insurance contract liabilities are analysed by line of business as follows:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| Credit protection | **60** | 94 |
| Home | **673** | 718 |
| Health | **2** | 2 |
| **Total gross non-life insurance contract liabilities** | **735** | 814 |

For non-life insurance contracts, the methodology and assumptions used in relation to determining the bases of the earned premium and claims provisioning levels are derived for each individual underwritten product. Assumptions are intended to be neutral estimates of the most likely or expected outcome. There has been no significant change in the assumptions and methodologies used for setting reserves.

The reserving methodology and associated assumptions are set out below:

The unearned premium reserve is determined on a basis that reflects the length of time for which contracts have been in force and the projected incidence of risk over the term of each contract.

Claims outstanding comprise those claims that have been notified and those that have been incurred but not reported. Claims incurred but not reported are determined based on the historical emergence of claims and their average cost. The notified claims element represents the best estimate of the cost of claims reported using projections and estimates based on historical experience.

The movements in non-life insurance contract liabilities and reinsurance assets over the year have been as follows:

| | Gross | Reinsurance | Net |
|---|---|---|---|
| | £m | £m | £m |
| Provisions for unearned premiums | | | |

| | | | |
|---|---|---|---|
| At 1 January 2012 | 566 | (23) | 543 |
| Increase in the year | 1,081 | (31) | 1,050 |
| Release in the year | (1,153) | 38 | (1,115) |
| Change in provision for unearned premiums charged to income statement (note 8) | (72) | 7 | (65) |
| At 31 December 2012 | 494 | (16) | 478 |
| Increase in the year | 972 | (18) | 954 |
| Release in the year | (1,021) | 24 | (997) |
| Change in provision for unearned premiums charged to income statement (note 8) | (49) | 6 | (43) |
| Exchange translation | (3) | – | (3) |
| At 31 December 2013 | 442 | (10) | 432 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 36: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS** continued

These provisions represent the liability for short-term insurance contracts for which the Group's obligations are not expired at the year end.

| | Gross £m | Reinsurance £m | Net £m |
|---|---|---|---|
| Claims outstanding | | | |
| Notified claims | 313 | (1) | 312 |
| Incurred but not reported | 82 | (1) | 81 |
| At 1 January 2012 | 395 | (2) | 393 |
| Cash paid for claims settled in the year | (455) | 1 | (454) |
| Increase (decrease) in liabilities: | | | |
| Arising from current year claims | 492 | – | 492 |
| Arising from prior year claims | (111) | – | (111) |
| Change in liabilities charged to income statement (note 10) | (74) | 1 | (73) |
| Exchange and over adjustments | (1) | – | (1) |
| At 31 December 2012 | 320 | (1) | 319 |
| Cash paid for claims settled in the year | (385) | – | (385) |
| Increase (decrease) in liabilities: | | | |
| Arising from current year claims | 379 | – | 379 |
| Arising from prior year claims | (27) | 1 | (26) |
| Change in liabilities charged to income statement (note 10) | (33) | 1 | (32) |
| Exchange and other adjustments | 6 | – | 6 |
| At 31 December 2013 | 293 | – | 293 |
| Notified claims | 263 | – | 263 |
| Incurred but not reported | 30 | – | 30 |
| At 31 December 2013 | 293 | – | 293 |
| Notified claims | 280 | – | 280 |
| Incurred but not reported | 40 | (1) | 39 |
| At 31 December 2012 | 320 | (1) | 319 |

**NON-LIFE INSURANCE CLAIMS DEVELOPMENT TABLE**

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year shown has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

**NON-LIFE INSURANCE ALL RISKS – GROSS**

| | 2007 £m | 2008 £m | 2009 £m | 2010 £m | 2011 £m | 2012 £m | 2013 £m | Total £m |
|---|---|---|---|---|---|---|---|---|
| **Accident year** | | | | | | | | |
| Estimate of ultimate claims costs: | | | | | | | | |
| At end of accident year | 317 | 205 | 639 | 609 | 446 | 421 | 349 | 2,986 |
| One year later | 311 | 199 | 539 | 517 | 366 | 382 | | |
| Two years later | 299 | 195 | 494 | 497 | 353 | | | |
| Three years later | 292 | 187 | 487 | 493 | | | | |
| Four years later | 285 | 186 | 483 | | | | | |
| Five years later | 286 | 186 | | | | | | |
| Six years later | 286 | | | | | | | |
| Current estimate in respect of above claims | 286 | 186 | 483 | 493 | 353 | 382 | 349 | 2,532 |
| Current estimate of claims relating to general insurance business acquired in 2009 | 388 | 256 | – | – | – | – | – | 644 |
| Current estimate of cumulative claims | 674 | 442 | 483 | 493 | 353 | 382 | 349 | 3,176 |
| Cumulative payments to date | (671) | (436) | (475) | (475) | (332) | (344) | (165) | (2,898) |
| Liability recognised in the balance sheet | 3 | 6 | 8 | 18 | 21 | 38 | 184 | 278 |
| Liability in respect of earlier years | | | | | | | | – |
| Total liability included in the balance sheet | | | | | | | | 278 |

The liability of £278 million shown in the above table excludes £10 million of unallocated claims handling expenses and £5 million of unexpired risk reserve.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 37: LIFE INSURANCE SENSITIVITY ANALYSIS**

The following table demonstrates the effect of reasonably possible changes in key assumptions on profit before tax and equity disclosed in these financial statements assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. These amounts include movements in assets, liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts. The impact is shown in one direction but can be assumed to be reasonably symmetrical.

| | **Change in variable** | Increase (reduction) in profit before tax £m | Increase (reduction) in equity £m |
|---|---|---|---|
| At 31 December 2013 | | | |
| Non-annuitant mortality and morbidity[1] | 5% reduction | 39 | 31 |
| Annuitant mortality[2] | 5% reduction | (151) | (121) |
| Lapse rates[3] | 10% reduction | 132 | 106 |
| Future maintenance and investment expenses[4] | 10% reduction | 194 | 155 |
| Risk-free rate[5] | 0.25% reduction | 50 | 40 |
| Guaranteed annuity option take up[6] | 5% addition | – | – |
| Equity investment volatility[7] | 1% addition | (8) | (6) |
| Widening of credit default spreads on corporate bonds[8] | 0.25% addition | (238) | (191) |
| Increase in illiquidity premia[9] | 0.10% addition | 82 | 66 |
| | Change in variable | Increase (reduction) in profit before tax £m | Increase (reduction) in equity £m |
| At 31 December 2012 | | | |
| Non-annuitant mortality and morbidity[1] | 5% reduction | 43 | 33 |
| Annuitant mortality[2] | 5% reduction | (170) | (131) |
| Lapse rates[3] | 10% reduction | 117 | 90 |
| Future maintenance and investment expenses[4] | 10% reduction | 199 | 153 |
| Risk-free rate[5] | 0.25% reduction | 26 | 20 |
| Guaranteed annuity option take up[6] | 5% addition | (9) | (7) |
| Equity investment volatility[7] | 1% addition | (7) | (5) |
| Widening of credit default spreads on corporate bonds[8] | 0.25% addition | (239) | (184) |
| Increase in illiquidity premia[9] | 0.10% addition | 93 | 72 |

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

1 This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

2 This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

3 This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

4 This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

5 This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

6 This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

7 This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

8 This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Swap curves, the risk-free rate and illiquidity premia are all assumed to be unchanged.

9 This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall spreads on assets are unchanged and hence market values are unchanged. Swap curves and the non-annuity risk-free rate are both assumed to be unchanged. The increased illiquidity premium increases the annuity risk-free rate.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 38: LIABILITIES ARISING FROM NON-PARTICIPATING INVESTMENT CONTRACTS**

The movement in liabilities arising from non-participating investment contracts may be analysed as follows:

| | Gross £m | Reinsurance £m | Net £m |
|---|---|---|---|
| At 1 January 2012 | 49,636 | (57) | 49,579 |
| New business | 4,236 | (1) | 4,235 |
| Changes in existing business | 526 | 12 | 538 |
| Exchange and other adjustments | (26) | – | (26) |
| At 31 December 2012 | 54,372 | (46) | 54,326 |
| New business | 1,294 | (1) | 1,293 |
| Changes in existing business | 1,899 | – | 1,899 |
| Disposal of business | (29,953) | – | (29,953) |
| Exchange and other adjustments | (22) | – | (22) |
| At 31 December 2013 | 27,590 | (47) | 27,543 |

**NOTE 39: UNALLOCATED SURPLUS WITHIN INSURANCE BUSINESSES**

The movement in the unallocated surplus within long-term insurance businesses over the year can be analysed as follows:

| | 2013 £m | 2012 £m |
|---|---|---|
| At 1 January | 267 | 300 |
| Change in unallocated surplus recognised in the income statement (note 10) | 123 | (31) |
| Exchange and other adjustments | 1 | (2) |
| At 31 December | 391 | 267 |

**NOTE 40: OTHER LIABILITIES**

| | 2013 £m | 2012[1] £m |
|---|---|---|
| Settlement balances | 3,358 | 2,040 |
| Unitholders’ interest in Open Ended Investment Companies | 22,219 | 33,651 |

| | | |
|---|---|---|
| Liabilities of disposal groups (note 16) | 7,302 | 214 |
| Other creditors and accruals | 7,728 | 10,888 |
| Total other liabilities | 40,607 | 46,793 |

[1] Restated – see note 1.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS**

| | 2013 £m | 2012[1] £m | 2011[1] £m |
|---|---|---|---|
| Charge to the income statement | | | |
| Past service charges (credits)[2] | 104 | (250) | – |
| Other | 392 | 349 | 395 |
| Defined benefit pension schemes | 496 | 99 | 395 |
| Other post-retirement benefit schemes | 7 | 11 | 13 |
| Total defined benefit schemes | 503 | 110 | 408 |
| Defined contribution pension schemes | 255 | 229 | 202 |
| Total charge to the income statement | 758 | 339 | 610 |

1 Restated – see note 1.

2 The Group has agreed certain changes to early retirement and commutation factors in two of its principal defined benefit pension schemes, resulting in a cost of £104 million recognised in the Group's income statement in the year ended 31 December 2013. In 2012, there was a net credit of £250 million following a decision to link discretionary pension increases in certain schemes to the Consumer Price Index (note 11).

| | 2013 £m | 2012[1] £m |
|---|---|---|
| Amounts recognised in the balance sheet | | |
| Retirement benefit assets | 98 | 741 |
| Retirement benefit obligations | (1,096) | (1,905) |
| Total amounts recognised in the balance sheet | (988) | (1,164) |

The total amount recognised in the balance sheet relates to:

| | **2013 £m** | 2012[1] £m |
|---|---|---|
| Defined benefit pension schemes | (787) | (957) |
| Other post-retirement benefit schemes | (211) | (207) |
| Total amounts recognised in the balance sheet | (998) | (1,164) |

1 Restated – see note 1.

**PENSION SCHEMES**

**DEFINED BENEFIT SCHEMES**

**(I) Characteristics of and risks associated with the Group's schemes**

The Group has established a number of defined benefit pension schemes in the UK and overseas. All significant schemes are based in the UK, with the three most significant being the defined benefit sections of the Lloyds Bank Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme. These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2013 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The Group operates a number of funded and unfunded pension arrangements, the majority, including the three most significant schemes, are funded schemes in the UK. All schemes are operated as separate legal entities under trust law by the trustees. All UK schemes are funded in compliance with the Pensions Act 2004. A valuation exercise is carried out for each scheme at least every three years, whereby scheme assets are measured at market value and liabilities ('Technical Provisions') are measured using prudent assumptions, if a deficit is identified a recovery plan is agreed and sent to the Pensions Regulator for review. The outcome of this valuation process, including agreement of any recovery plans, is agreed between the Group and the scheme Trustee. The Group's overseas defined benefit pension schemes are subject to local regulatory arrangements.

The latest full valuations of the three main schemes were carried out as at 30 June 2011; the results have been updated to 31 December 2013 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2013 by qualified independent actuaries.

During 2009, the Group made one-off contributions to the Lloyds Bank Pension Scheme No 1 and Lloyds Bank Pension Scheme No 2 of approximately £1 billion in aggregate. These contributions took the form of interests in limited liability partnerships for each of the two schemes which contained assets of approximately £5.4 billion in aggregate entitling the schemes to annual payments of approximately £215 million in aggregate until 31 December 2014. Thereafter, assuming that all distributions have been made, the value of the partnership interests will equate to a nominal amount. At 31 December 2013, the limited liability partnerships held assets of approximately £5.4 billion and cash payments of £215 million were made to the pension schemes during the year (2012: £215 million). The limited liability partnerships are consolidated fully in the Group's balance sheet (see note 22).

The Group has also established two private limited companies which hold assets to provide security for the Group's obligations to the HBOS Final Salary Pension Scheme and a section of the Lloyds Bank Pension Scheme No 1. At 31 December 2013 these held assets of approximately £2.6 billion in aggregate; they do not make any distributions to the pension schemes. The private limited companies are consolidated fully in the Group's balance sheet.

The terms of these arrangements require the Group to maintain assets in these vehicles to agreed minimum values in order to secure obligations owed to the relevant Group pension schemes. The Group has satisfied this requirement during 2013.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS** continued

The Group currently expects to pay contributions of approximately £525 million to its defined benefit schemes in 2014.

The responsibility for the governance of the Group's funded defined benefit pension schemes lies with the Pension Trustees. Each of the Group's funded UK defined benefit pension schemes are managed by a Trustee Board (the Trustee) whose role is to ensure that their Scheme is administered in accordance with the Scheme rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the triennial valuation process. The Board of Trustees must be composed of representatives of the Company and plan participants in accordance with the Scheme's regulations.

**(II) Amounts in the financial statements**

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Amount included in the balance sheet | | |
| Present value of funded obligations | (33,355) | (31,324) |
| Fair value of scheme assets | 32,568 | 30,367 |
| Net amount recognised in the balance sheet | (787) | (957) |

| | **2013** | 2012 |
|---|---|---|
| | £m | £m |
| Net amount recognised in the balance sheet | | |
| At 1 January | (957) | 592 |
| Net defined benefit pension expense | (496) | (99) |
| Actuarial losses on defined benefit obligation | (1,265) | (2,607) |
| Return on plan assets | 1,133 | 484 |
| Employer contributions | 804 | 669 |
| Exchange and other adjustments | (6) | 4 |
| At 31 December | (787) | (957) |

| | 2013 | 2012 |
|---|---|---|
| | **£m** | £m |
| Movements in the defined benefit obligation | | |
| At 1 January | (31,324) | (28,236) |
| Current service cost | (351) | (360) |
| Interest expense | (1,414) | (1,373) |
| Remeasurements: | | |

| | | |
|---|---|---|
| Actuarial (losses) gains – experience | 184 | (495 ) |
| Actuarial (losses) gains – demographic assumptions | 15 | (233 ) |
| Actuarial (losses) gains – financial assumptions | (1,464 ) | (1,879 ) |
| Benefits paid | 1,061 | 995 |
| Past service cost | (5 ) | (16 ) |
| Employee contributions | (3 ) | (3 ) |
| Curtailments | (104 ) | 250 |
| Settlements | 62 | 12 |
| Exchange and other adjustments | (12 ) | 14 |
| At 31 December | (33,355) | (31,324) |
| The total defined benefit obligation comprises: | | |
| Amounts owing to active members | (8,647 ) | (8,004 ) |
| Amounts owing to deferred members | (9,927 ) | (8,927 ) |
| Amounts owing to pensioners | (13,547) | (13,207) |
| Amounts owing to dependents | (1,234 ) | (1,186 ) |
| Total defined benefit obligation at 31 December | (33,355) | (31,324) |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS** continued

| | 2013 £m | 2012 £m |
|---|---|---|
| Changes in the fair value of scheme assets | | |
| At 1 January | 30,367 | 28,828 |
| Return on plan assets excluding amounts included in interest income | 1,133 | 484 |
| Interest income | 1,392 | 1,433 |
| Employer contributions | 804 | 669 |
| Employee contributions | 3 | 3 |
| Benefits paid | (1,061 ) | (995 ) |
| Settlements | (55 ) | (16 ) |
| Administrative costs paid | (21 ) | (29 ) |
| Exchange and other adjustments | 6 | (10 ) |
| At 31 December | 32,568 | 30,367 |

Composition of scheme assets:

| | **2013** | | | 2012 | | |
|---|---|---|---|---|---|---|
| | **Quoted £m** | **Unquoted £m** | **Total £m** | Quoted £m | Unquoted £m | Total £m |
| Equity instruments | 1,276 | – | 1,276 | 2,016 | – | 2,016 |
| Debt instruments | 12,845 | – | 12,845 | 10,704 | – | 10,704 |
| Property | – | 1,062 | 1,062 | – | 1,100 | 1,100 |
| Pooled investment vehicles | 4,684 | 10,671 | 15,355 | 4,337 | 10,975 | 15,312 |
| Money market instruments, cash, derivatives and other assets and liabilities | 506 | 1,524 | 2,030 | 522 | 713 | 1,235 |
| At 31 December | 19,311 | 13,257 | 32,568 | 17,579 | 12,788 | 30,367 |

The assets of all the funded plans are held independently of the Group's assets in separate trustee administered funds.

An analysis by credit rating of the pension schemes' debt securities is provided below:

| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Fixed interest government bonds | 877 | 884 | 143 | 218 | 80 | – | 2,202 |
| Index linked government bonds | 6,955 | – | – | – | – | – | 6,955 |
| Corporate and other debt securities | 127 | 442 | 1,305 | 1,206 | 482 | 75 | 3,637 |
| Asset-backed securities | – | – | – | – | – | 51 | 51 |
| Total debt securities | 7,959 | 1,326 | 1,448 | 1,424 | 562 | 126 | 12,845 |
| At 31 December 2012 | | | | | | | |
| Fixed interest government bonds | 772 | 97 | 29 | 94 | – | – | 992 |
| Index linked government bonds | 6,288 | – | – | – | – | – | 6,288 |
| Corporate and other debt securities | 153 | 478 | 1,289 | 835 | 243 | 85 | 3,083 |
| Asset-backed securities | – | – | 27 | 208 | 57 | 49 | 341 |
| Total debt securities | 7,213 | 575 | 1,345 | 1,137 | 300 | 134 | 10,704 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS** continued

The pension schemes' pooled investment vehicles comprise:

| | 2013 £m | 2012 £m |
|---|---|---|
| UK equity investment funds | 457 | 2,996 |
| Non-UK equity investment funds | 2,177 | 2,265 |
| Fixed interest and index linked government bond funds | 277 | 331 |
| Corporate bond funds | 469 | 466 |
| Private equity | 963 | 902 |
| Infrastructure funds | 690 | 635 |
| Property partnerships and unit trusts | 383 | 427 |
| Hedge and mutual funds | 2,382 | 1,846 |
| Reinsurance (OEICs) vehicles | 654 | 315 |
| Mezzanine debt funds | 108 | 111 |
| Long-term equity funds | 84 | 114 |
| Emerging market equity funds | 1,018 | 1,051 |
| Emerging market debt funds | 1,142 | 705 |
| Multi strategy alternative credit funds | 749 | – |
| Asset-backed pension contribution schemes | 214 | 429 |
| Liquidity funds | 3,588 | 2,719 |
| At 31 December | 15,355 | 15,312 |

The expense recognised in the income statement for the year ended 31 December comprises:

| | 2013 £m | 2012 £m | 2011 £m |
|---|---|---|---|
| Current service cost | 351 | 360 | 380 |
| Net interest amount | 22 | (60 ) | (20 ) |
| Past service credits and curtailments (see below) | 104 | (250) | (25 ) |
| Settlements | (7 ) | 4 | 8 |
| Past service cost – plan amendments | 5 | 16 | 20 |
| Plan administration costs incurred during the year | 21 | 29 | 32 |
| Total defined benefit pension expense | 496 | 99 | 395 |

The Group has agreed certain changes to early retirement and commutation factors in two of its principal defined benefit pension schemes, resulting in a cost of £104 million recognized in the Group's income statement in the year ended 31 December 2013. In 2012, there was a net credit of £250 million following a decision to link discretionary pension increases in certain schemes to the Consumer Price Index (note 11).

ASSUMPTIONS

The principal actuarial and financial assumptions used in valuations of the defined benefit pension schemes were as follows:

| | 2013 | 2012 |
|---|---|---|
| | % | % |
| Discount rate | 4.60 | 4.60 |
| Rate of inflation: | | |
| Retail Prices Index | 3.30 | 2.90 |
| Consumer Price Index | 2.30 | 2.00 |
| Rate of salary increases | 2.00 | 2.00 |
| Rate of increase for pensions in payment | 2.80 | 2.70 |
| | 2013 | 2012 |
| | **Years** | Years |
| Life expectancy for member aged 60, on the valuation date: | | |
| Men | 27.4 | 27.4 |
| Women | 29.7 | 29.7 |
| Life expectancy for member aged 60, 15 years after the valuation date: | | |
| Men | 28.6 | 28.5 |
| Women | 31.0 | 30.9 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS** continued

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 at 31 December 2013 is assumed to live for, on average, 27.4 years for a male and 29.7 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

**(III) AMOUNT TIMING AND UNCERTAINTY OF FUTURE CASH FLOWS**

Risk exposure of the defined benefit schemes

Whilst the Group is not exposed to any unusual, entity specific or scheme specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

**Inflation rate risk:** the majority of the plans’ benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

**Interest rate risk:** The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings.

**Longevity risk:** The majority of the schemes obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans’ liabilities.

**Investment risk:** Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

SENSITIVITY ANALYSIS

The effect of reasonably possible changes in key assumptions on the value of scheme liabilities and the resulting pension charge in the Group's income statement and on the net defined benefit pension scheme liability, for the Group's three most significant schemes, is set out below. The sensitivities provided assume that all other assumptions and the value of the schemes' assets remain unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

| | **Effect of reasonably possible alternative assumptions** | | | |
|---|---|---|---|---|
| | **Increase (decrease) in the income statement charge** | | **Increase (decrease) in the net defined benefit pension scheme liability** | |
| | **2013 £m** | 2012 £m | **2013 £m** | 2012 £m |
| Inflation(including pension increases):[1] | | | | |
| Increase of 0.5 per cent | **108** | 137 | **1,833** | 2,362 |
| Decrease of 0.5 per cent | **(93 )** | (110 ) | **(1,706)** | (1,888) |
| Discount rate:[2] | | | | |
| Increase of 0.5 per cent | **(166 )** | (152 ) | **(2,638)** | (2,396) |
| Decrease of 0.5 per cent | **155** | 151 | **2,890** | 2,740 |
| Expected life expectancy of members: | | | | |
| Increase of one year | **38** | 40 | **686** | 675 |
| Decrease of one year | **(36 )** | (39 ) | **(676 )** | (664 ) |

[1] At 31 December 2013, the assumed rate of RPI inflation is 3.3 per cent and CPI inflation 2.3 per cent (2012: RPI 2.90 per cent and CPI 2.00 per cent).

[2] At 31 December 2013, the assumed discount rate is 4.6 per cent (2012: 4.60 per cent).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS** continued

SENSITIVITY ANALYSIS METHOD AND ASSUMPTIONS

The sensitivity analysis above reflects the impact on the Group's three most significant schemes which account for over 90 per cent of the Group's defined benefit obligations. Whilst differences in the underlying liability profiles for the remainder of the Group's pension arrangements mean they may exhibit slightly different sensitivities to variations in these assumptions, the sensitivities provided above are indicative of the impact across the Group as a whole.

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), and include the impact on the rate of increases to pensions, both before and after retirement. These pension increases are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits.

The sensitivity analysis (including the inflation sensitivity) does not include the impact of any possible change in the rate of salary increases. These increases are capped at a maximum of 2 per cent per annum, and have been assumed to increase at this maximum rate in both 2012 and 2013, therefore there is no sensitivity to an increase in this assumption. The Group is currently in formal consultation with the members of its defined benefit pension schemes regarding proposed changes to the way pensionable pay is calculated, which if introduced would reduce the rate of salary increases to zero. If implemented these changes would have the effect of decreasing both the Group's income statement charge and net defined benefit scheme liability.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the re-stated prior year.

ASSET-LIABILITY MATCHING STRATEGIES

The main schemes' assets are invested in a diversified portfolio, consisting primarily of debt securities and equities. The investment strategy is not static and will evolve to reflect the structure of liabilities within the schemes. Specific asset-liability matching strategies for each pension plan are independently determined by the responsible governance body for each scheme and in consultation with the employer.

A significant goal of the asset-liability matching strategies adopted by Group schemes is to reduce volatility caused by changes in market expectations of interest rates and inflation. In the main, this is achieved by investing scheme assets in bonds, primarily fixed interest gilts and index linked gilts, and by entering into interest rate and inflation swap arrangements. These investments are structured to take into account the profile of scheme liabilities, and actively managed to reflect both changing market conditions and changes to the liability profile.

The current asset-liability matching strategy has the objective of mitigating approximately 54 per cent (2012: 45 per cent) of the interest rate volatility and 71 per cent (2012: 54 per cent) of the inflation rate volatility of the liabilities.

MATURITY PROFILE OF DEFINED BENEFIT OBLIGATION

The following table provides information on the weighted average duration of the defined benefit pension obligations and the distribution and timing of benefit payments:

| | **2013** | 2012 |
|---|---|---|
| | **Years** | Years |
| Duration of the defined benefit obligation | **19** | 19 |
| | **2013** | 2012 |
| | **£m** | £m |
| Maturity analysis of benefits expected to be paid | | |
| Benefits expected to be paid within 12 months | **1,067** | 999 |
| Benefits expected to be paid between 1 and 2 years | **1,009** | 970 |
| Benefits expected to be paid between 2 and 5 years | **3,420** | 3,210 |
| Benefits expected to be paid between 5 and 10 years | **7,207** | 6,739 |
| Benefits expected to be paid between 10 and 15 years | **8,945** | 8,446 |
| Benefits expected to be paid between 15 and 25 years | **21,102** | 20,072 |
| Benefits expected to be paid between 25 and 35 years | **20,851** | 19,767 |
| Benefits expected to be paid between 35 and 45 years | **16,374** | 15,508 |
| Benefits expected to be paid in more than 45 years | **11,403** | 11,096 |

MATURITY ANALYSIS METHOD AND ASSUMPTIONS

The projected benefit payments are based on the assumptions underlying the assessment of the obligations, including allowance for expected future inflation. They are shown in their undiscounted form and therefore appear large relative to the discounted assessment of the defined benefit obligations recognised in the Group's balance sheet. They are in respect of benefits that have been accrued prior to the respective year-end date only and make no allowance for any benefits that may have been accrued subsequently.

**DEFINED CONTRIBUTION SCHEMES**

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow and the defined contribution sections of the Lloyds Bank Pension Scheme No. 1.

During the year ended 31 December 2013 the charge to the income statement in respect of defined contribution schemes was £255 million (2012: £229 million; 2011: £202 million), representing the contributions payable by the employer in accordance with each scheme's rules.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 41: RETIREMENT BENEFIT OBLIGATIONS** continued

**OTHER POST-RETIREMENT BENEFIT SCHEMES**

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2008; this valuation has been updated to 31 December 2013 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.90 per cent (2012: 6.50 per cent).

Movements in the other post-retirement benefits obligation:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **(207 )** | (188 ) |
| Exchange and other adjustments | **–** | (3 ) |
| Actuarial loss | **(4 )** | (13 ) |
| Insurance premiums paid | **7** | 8 |
| Charge for the year | **(7 )** | (11 ) |
| At 31 December | **(211 )** | (207 ) |

**NOTE 42: DEFERRED TAX**

The movement in the net deferred tax balance is as follows:

| | **2013** | 2012 |
|---|---|---|

| | **£m** | £m |
|---|---|---|
| Asset at 1 January | | |
| As previously reported | | 4,182 |
| Restatement (notes 1 and 56) | | 139 |
| Restated | **4,586** | 4,321 |
| Exchange and other adjustments | **7** | (14 ) |
| Disposals | **558** | – |
| Income statement (charge) credit (note 14): | | |
| Due to change in UK corporation tax rate | **(594 )** | (320 ) |
| Other | **(158 )** | (244 ) |
| | **(752 )** | **(564 )** |
| Amount credited (charged) to equity: | | |
| Post-retirement defined benefit scheme remeasurements | **28** | 491 |
| Available-for-sale financial assets (note 47) | **274** | 344 |
| Cash flow hedges (note 47) | **374** | 1 |
| Share-based compensation | **26** | 7 |
| | **702** | 843 |
| Asset at 31 December | **5,101** | 4,586 |

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

| | **2013** | 2012 | | **2013** | 2012 |
|---|---|---|---|---|---|
| **Statutory position** | **£m** | £m | **Tax disclosure** | **£m** | £m |
| Deferred tax assets | **5,104** | 4,913 | Deferred tax assets | **8,097** | 8,997 |
| Deferred tax liabilities | **(3 )** | (327 ) | Deferred tax liabilities | **(2,996)** | (4,411) |
| **Asset at 31 December** | **5,101** | 4,586 | **Asset at 31 December** | **5,101** | 4,586 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 42: DEFERRED TAX** continued

The deferred tax (charge) credit in the income statement comprises the following temporary differences:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Accelerated capital allowances | **482** | 410 | 319 |
| Pensions and other post-retirement benefits | **(14)** | (237) | (120) |
| Long-term assurance business | **86** | (869) | 596 |
| Allowances for impairment losses | **(86)** | (332) | (56) |
| Tax losses carried forward | **(1,049)** | 974 | (919) |
| Tax on fair value of acquired assets | **322** | 28 | (107) |
| Other temporary differences | **(493)** | (538) | 577 |
| **Deferred tax (charge) credit in the income statement** | **(752)** | (564) | 290 |

Deferred tax assets and liabilities are comprised as follows:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| Deferred tax assets: | | |
| Pensions and other post-retirement benefits | **288** | 271 |
| Accelerated capital allowances | **649** | 167 |
| Allowances for impairment losses | **22** | 227 |
| Other provisions | **45** | 109 |
| Available-for-sale asset revaluation | **–** | 286 |
| Tax losses carried forward | **6,338** | 7,034 |
| Other temporary differences | **755** | 903 |
| **Total deferred tax assets** | **8,097** | 8,997 |
| | **2013** | 2012 |
| | **£m** | £m |
| Deferred tax liabilities: | | |
| Accelerated capital allowances | **–** | – |
| Long-term assurance business | **(1,195)** | (1,849) |
| Available-for-sale asset revaluation | **(30)** | – |
| Tax on fair value of acquired assets | **(1,236)** | (1,741) |
| Effective interest rates | **(19)** | (34) |
| Derivatives | **(190)** | (333) |
| Other temporary differences | **(326)** | (454) |
| **Total deferred tax liabilities** | **(2,996)** | (4,411) |

The Finance Act 2013 (the Act) was substantively enacted on 2 July 2013. The Act further reduced the main rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015. The change in the main rate of corporation tax from 23 per cent to 20 per cent has resulted in a reduction in the Group's net deferred tax asset at 31 December 2013 of £636 million, comprising the £594 million charge included in the income statement and a £42 million charge included in equity.

**DEFERRED TAX ASSETS**

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised deferred tax assets of £6,338 million (2012: £7,034 million) in relation to trading tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset (see note 3).

Deferred tax assets of £168 million (2012: £330 million) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

Deferred tax assets of £593 million (2012: £939 million) have not been recognised in respect of trading losses carried forward, mainly in certain overseas companies and in respect of other temporary differences in the insurance businesses. Trading losses can be carried forward indefinitely, except for losses in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward at 31 December 2013 of £41 million (2012: £42 million), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 43: OTHER PROVISIONS**

| | **Provisions for commitments £m** | **Payment protection insurance £m** | **Other regulatory provisions £m** | **Vacant leasehold property £m** | **Other £m** | **Total £m** |
|---|---|---|---|---|---|---|
| At 1 January 2013 | **66** | **2,431** | **935** | **73** | **456** | **3,961** |
| Exchange and other adjustments | **(40)** | **–** | **12** | **19** | **(32)** | **(41)** |
| Provisions applied | **–** | **(2,674)** | **(360)** | **(28)** | **(10)** | **(3,072)** |
| Charge for the year | **–** | **3,050** | **421** | **5** | **13** | **3,489** |
| **At 31 December 2013** | **26** | **2,807** | **1,008** | **69** | **427** | **4,337** |

**PROVISIONS FOR COMMITMENTS**

Provisions are held in cases where the Group is irrevocably committed to advance additional funds, but where there is doubt as to the customer's ability to meet its repayment obligations.

**PAYMENT PROTECTION INSURANCE**

Following the unsuccessful legal challenge by the BBA against the Financial Services Authority (FSA) and the Financial Ombudsman Service (FOS), the Group made provisions totalling £6,775 million in 2010 and 2012 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administrative expenses.

During 2013 average monthly customer initiated complaints have continued to fall. Good progress has also been made in the planned proactive mailings. There have been some adverse trends (as detailed below), and a further £3,050 million has been added to the provision, of which £500 million was at the half year, £750 million in the third quarter and £1,800 million at the year end. This brings the total amount provided to £9,825 million, of which approximately £2,090 million relates to anticipated administrative expenses. As at 31 December 2013, £2,807 million of the provision remained unutilised (29 per cent of total provision) relative to an average monthly spend including administration costs in the last six months of £230 million. The increase of £3,050 million in 2013, and the overall provision, is underpinned by the following drivers:

**– Volumes of customer initiated complaints (after excluding complaints from customers where no PPI policy was held)** – at 31 December 2012, the provision assumed a total of 2.3 million complaints would be received. Average monthly volumes in 2013 decreased by 54 per cent compared to 2012, and fourth quarter volumes fell in line with the Group's revised end third quarter expectations. However, following further statistical modelling and the results of a customer survey, the Group is now forecasting a slower decline in future volumes than previously expected. A further provision of £870 million was therefore made during the year to reflect this. Approximately 2.5 million complaints have been received to date, with the provision assuming approximately 550,000 in the future compared to an average run-rate of approximately 37,000 per month in the last three months. The table below details the historical complaint trends.

**Average monthly complaint volumes – reactive**

| Q1 2012 | Q2 2012 | Q3 2012 | Q4 2012 | **Q1 2013** | **Q2 2013** | **Q3 2013** | **Q4 2013** |
|---|---|---|---|---|---|---|---|
| 109,893 | 130,752 | 110,807 | 84,751 | **61,259** | **54,086** | **49,555** | **37,457** |

– **Proactive Mailing resulting from Past Business Reviews (PBR)** – the Group is proactively mailing customers where it has been identified that there was a risk of potential mis-sale. During the year, further groups of customers have been added to the proactive mailing exercise increasing the scope to 2.8 million policies, including approximately 300,000 additional policies in the second half. This, combined with higher than expected response rates from customers covered by the proactive mailing, resulted in a further provision of £470 million for the full year to reflect the additional cost incurred to date and in relation to future mailings.

– **Uphold rates** – average uphold rates per policy have increased from 61 per cent during the first half to 80 per cent for the last six months, with an average of 81 per cent in the fourth quarter. This reflects the impact of changes to the complaint handling policy, in part following consultation with the Financial Conduct Authority (FCA) and feedback from the FOS. In addition to this, there was a greater proportion of proactive mailing complaints received during the period for which uphold rates are higher. The provision assumes a slightly higher uphold rate going forward to allow for further embedding of complaint handling policy changes. The impact of higher uphold rates has resulted in a £335 million increase to the provision.

– **Average redress** – the average redress paid per policy has been relatively stable, but remains higher than expected by approximately £160 per policy due to the product and age mix of the complaints. This has resulted in an additional provision of £135 million.

– **Re-review of previously handled cases** – previously reviewed complaints are being assessed to ensure consistency with the current complaint handling policy. At 31 December 2012 the expected level of re-review was minimal. During 2013, and most notably in the fourth quarter, this has increased to approximately 590,000 cases at an estimated cost of £460 million.

– **Expenses** – given the update to volume related assumptions, the Group has also increased its estimate for administrative expenses which comprise complaint handling costs and costs arising from cases subsequently referred to the FOS, by £780 million.

An Enforcement Team of the FCA is investigating the Group's governance of third party suppliers and potential failings in the PPI complaint handling process. A provision of £50 million has been made in respect of the likely administration costs of responding to the FCA's inquiries. It is not possible at this stage to make any assessment of what, if any, additional liability may result from the investigation.

Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 40 per cent of the policies sold since 2000, covering both customer-initiated complaints and actual and expected proactive mailings undertaken by the Group. The total amount provided for PPI represents the Group's best estimate of the likely future costs, albeit a number of risks and uncertainties remain, in particular complaint volumes, uphold rates, average redress paid, the scope and cost of proactive mailings and

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 43: OTHER PROVISIONS** continued

remediation, and the outcome of the FCA Enforcement Team investigation. The cost of these factors could differ materially from the Group's estimates and the assumptions underpinning them and could result in a further provision being required.

Key metrics and sensitivities are highlighted in the table below:

| **Sensitivities**[1] | **To date unless noted** | **Future** | **Sensitivity** |
| --- | --- | --- | --- |
| Customer initiated complaints since origination (m) | **2.5** | **0.5** | **0.1 = £200m** |
| Proactive Mailing: – number of policies (m)[2] | **1.66** | **1.19** | **0.1 = £45m** |
| – response rate[3] | **37%** | **31%** | **1% = £20m** |
| Average uphold rate per policy[4] | **80%** | **83%** | **1% = £15m** |
| Average redress paid per upheld policy[5] | **£1,600** | **£1,600** | **£100 = £110m** |
| Remediation cases (k) | **21** | **569** | **1 Case = £770** |
| Administrative expenses (£m) | **1,410** | **680** | **1 Case = £500** |
| FOS Referral Rate[6] | **35%** | **36%** | **1% = £4m** |
| FOS Overturn Rate[7] | **49%** | **33%** | **1% = £2m** |

1 All sensitivities exclude claims where no PPI policy was held.

2 To date volume includes customer initiated complaints.

3 Metric has been adjusted to include mature mailings only, and exclude expected customer initiated complaints. Future response rates are expected to be lower than experienced to date as mailings to higher risk customers have been prioritised.

4 The percentage of complaints where the Group finds in favour of the customer. This is a blend of proactive and customer initiated complaints. The 80 per cent uphold rate is based on the latest six months to December 2013.

5 The amount that is paid in redress in relation to a policy found to have been mis-sold, comprising, where applicable, the refund of premium, compound interest charged and interest at 8 per cent per annum. Actuals are based on six months to December 2013. The accumulation of interest on future redress is expected to be offset by the mix shifting away from more expensive cases.

6 The percentage of cases reviewed by the Group that are subsequently referred to the FOS by the customer. A complaint is considered mature when six months have elapsed since initial decision. Actuals are based on decision made by the Group during January to June 2013 and subsequently referred to the FOS.

7 The percentage of complaints referred where the FOS arrive at a different decision to the Group. Actuals are based on six months to December 2013. The future overturn rate is expected to be lower due to changes in the case review

process implemented during 2013 which has resulted in a higher uphold rate as noted above. In turn this reduces the number / percentage of cases likely to be overturned by the FOS.

**OTHER REGULATORY PROVISIONS**

**LITIGATION IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY**

Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group recognised a further provision of £150 million in its accounts for the year ended 31 December 2012 bringing the total amount provided to £325 million. During the half-year to 30 June 2013 the Group has charged a further £75 million with respect to this litigation increasing the total provision to £400 million. The remaining unutilised provision as at 31 December 2013 is £246 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the validity of any of the claims facing CMIG will turn upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once there is further clarity with respect to a range of legal issues and factual determinations involved in these claims and/or all relevant claims have been resolved.

**INTEREST RATE HEDGING PRODUCTS**

In June 2012, a number of banks, including the Group, reached agreement with the FSA (now FCA) to carry out a review of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. As at 31 December 2013 the Group had identified 1,771 sales of IRHPs to customers within scope of the agreement with the FCA which are being reviewed and, where appropriate, redressed. The Group agreed that on conclusion of this review it would provide redress to any in-scope customers where appropriate.

The Group provided £400 million in its accounts for the year ended 31 December 2012 for the estimated cost of redress and related administration costs, based on a pilot review that had been conducted at the time. In the final quarter of 2013, a significant number of additional cases were reviewed, providing a larger and more representative sample from which to estimate the total cost of the review. As a result, an additional provision of £130 million has been recognised. During the same period, the Group confirmed it would pay any redress due to in-scope customers before any consequential loss claims had been outlined and agreed with them. At 31 December 2013, the total amount provided for the cost of redress and related administration costs is £530 million of which £162 million had been utilised. No provision has been recognised in relation to claims from customers which are not covered by the agreement with the FCA, or incremental claims from customers within the scope of the review. These will be monitored and future provisions will be recognised to the extent an obligation resulting in a probable outflow is identified.

**OTHER REGULATORY MATTERS**

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and governmental authorities in relation to a range of matters; a provision is held against the costs expected to be incurred as a result of the conclusions reached. In 2013 the provision was increased by a further £200 million, in respect of matters affecting the Retail, Commercial, and Wealth and Asset Finance businesses, bringing the total amount charged to £300 million of which £75 million had been utilised at 31 December 2013. This increase reflects the Group’s assessment of a limited number of matters under discussion, none of which currently is individually considered financially material in the context of the Group.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 43: OTHER PROVISIONS** continued

**VACANT LEASEHOLD PROPERTY**

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging three years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.)

**OTHER**

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

Other provisions include those arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate cost and timing of payments are uncertain. The provision held of £37 million at 31 December 2013 represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

**NOTE 44: SUBORDINATED LIABILITIES**

| | 2013<br>**£m** | 2012<br>£m |
|---|---|---|
| Preference shares | 876 | 1,385 |
| Preferred securities | 4,301 | 4,394 |
| Undated subordinated liabilities | 1,916 | 1,927 |
| Enhanced Capital Notes | 8,938 | 8,947 |
| Dated subordinated liabilities | 16,281 | 17,439 |
| **Total subordinated liabilities** | 32,312 | 34,092 |

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. The subordination of the dated Enhanced Capital Notes (ECNs) ranks equally with that of the dated subordinated liabilities. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2012: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Prudential Regulatory Authority.

The movement in subordinated liabilities during the year was as follows:

| | **2013** | 2012 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **34,092** | 35,089 |
| Issued during the year | **1,500** | 128 |
| Repurchases and redemptions during the year | **(2,442 )** | (857 ) |
| Foreign exchange and other movements | **(838 )** | (268 ) |
| **At 31 December** | **32,312** | 34,092 |

| | Note | **2013** £m | 2012 £m |
|---|---|---|---|
| Preference shares | | | |
| 6% Non-cumulative Redeemable Preference Shares | a | **–** | – |
| 7.875% Non-cumulative Preference Shares callable 2013 (US$1,250 million) | | **–** | 259 |
| 7.875% Non-cumulative Preference Shares callable 2013 (€500 million) | | **–** | 149 |
| 6.0884% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million) | | **10** | 10 |
| 5.92% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million) | | **127** | 125 |
| 6.267% Non-cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million) | | **274** | 280 |
| 6.3673% Non-cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million) | | **2** | 2 |
| 6.475% Non-cumulative Preference Shares callable 2024 (£186 million) | | **39** | 39 |
| 6.413% Non-cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million) | | **51** | 104 |
| 6.657% Non-cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million) | | **16** | 14 |
| 9.25% Non-cumulative Irredeemable Preference Shares (£300 million) | | **304** | 350 |
| 9.75% Non-cumulative Irredeemable Preference Shares (£100 million) | | **53** | 53 |
| **Total preference shares** | | **876** | 1,385 |

a Since 2004, the Company has had in issue 400 6 per cent non-cumulative preference shares of 25p each. The shares, which are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Company.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 44: SUBORDINATED LIABILITIES** continued

| | Note | **2013 £m** | 2012 £m |
|---|---|---|---|
| Preferred securities | | | |
| 6.90% Perpetual Capital Securities (US$1,000 million) | a | **209** | 214 |
| 6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million) | a | **121** | 238 |
| 8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million) | a, b | **256** | 262 |
| 7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million) | a, c, e | **66** | 50 |
| 6.35% Step-up Perpetual Capital Securities (€500 million) | a, d | **212** | 226 |
| 6.071% Non-cumulative Perpetual Preferred Securities (US$750 million) | | **423** | 382 |
| 7.834% Sterling Step-up Non-voting Non-cumulative Preferred Securities callable 2015 (£250 million) | | **5** | 5 |
| 4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million) | | **26** | 23 |
| 7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million) | | **132** | 128 |
| 4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million) | | **89** | 83 |
| 6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million) | | **455** | 439 |
| 13% Step-up Perpetual Capital Securities callable 2019 (£785 million) | | **8** | 8 |
| 13% Step-up Perpetual Capital Securities callable 2019 (€532 million) | | **50** | 48 |
| 7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million) | | **101** | 98 |
| 12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US$2,000 million) | | **1,211** | 1,239 |
| 7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million) | | **90** | 95 |
| 13% Step-up Perpetual Capital Securities callable 2029 (£700 million) | | **660** | 629 |
| 7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million) | | **187** | 227 |
| Total preferred securities | | **4,301** | 4,394 |

a These securities have passed their first call date, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the PRA.

b The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.

c The fixed rate on this security was reset from 7.627 per cent to 3 month Euribor plus 2.875 per cent with effect from 9 December 2011.

d The fixed rate on this security was reset from 6.35 per cent to 3 month Euribor plus 2.50 per cent with effect from 25 February 2013.

e Following an exchange in February 2012, certain holders elected to exchange some notes into a new series of dated subordinated securities issued by Lloyds Bank plc.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 44: SUBORDINATED LIABILITIES** continued

| | Note | **2013 £m** | 2012 £m |
|---|---|---|---|
| **Undated subordinated liabilities** | | | |
| 6.625% Undated Subordinated Step-up Notes (£410 million) | a, b | **6** | 6 |
| Floating Rate Undated Subordinated Step-up Notes (€300 million) | a | **16** | 13 |
| 6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million) | a, c | **8** | 5 |
| 5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million) | | **–** | 9 |
| 8.625% Perpetual Subordinated Notes (£200 million) | | **–** | 22 |
| 4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million) | | **79** | 70 |
| Floating Rate Undated Subordinated Notes (€500 million) | | **49** | 44 |
| 4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes (€750 million) (Clerical Medical Finance plc) | | **283** | 261 |
| 10.25% Subordinated Undated Instruments (£100 million) | | **1** | 1 |
| 5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) (Scottish Widows plc) | | **533** | 556 |
| 5.125% Undated Subordinated Fixed to Floating Notes (€750 million) | | **49** | 45 |
| 7.5% Undated Subordinated Step-up Notes (£300 million) | | **5** | 4 |
| 5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million) | | **2** | 2 |
| 6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million) | | **1** | 1 |
| 7.375% Undated Subordinated Guaranteed Bonds (£200 million) (Clerical Medical Finance plc) | | **44** | 37 |
| 5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million) | | **5** | 1 |
| 12% Perpetual Subordinated Bonds (£100 million) | | **20** | 21 |
| 5.75% Undated Subordinated Step-up Notes (£600 million) | | **3** | 3 |
| 8.75% Perpetual Subordinated Bonds (£100 million) | | **5** | 5 |
| 8% Undated Subordinated Step-up Notes callable 2023 (£200 million) | | **–** | – |
| 9.375% Perpetual Subordinated Bonds (£50 million) | | **14** | 14 |
| 5.75% Undated Subordinated Step-up Notes (£500 million) | | **4** | 4 |
| 6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million) | | **–** | – |
| 6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million) | | **10** | 10 |
| Floating Rate Primary Capital Notes (US$250 million) | a | **109** | 111 |
| Primary Capital Undated Floating Rate Notes: | | | |
| Series 1 (US$750 million) | a | **162** | 165 |
| Series 2 (US$500 million) | a | **169** | 173 |
| Series 3 (US$600 million) | a | **218** | 223 |
| 13.625% Perpetual Subordinated Bonds (£75 million) | | **19** | 19 |
| 11.75% Perpetual Subordinated Bonds (£100 million) | | **102** | 102 |
| **Total undated subordinated liabilities** | | **1,916** | 1,927 |

a These securities have passed their first call date, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the PRA.

b The fixed rate on this security was reset from 6.625 per cent to 4.64821 per cent with effect from 15 July 2010.

c The fixed rate on this security was reset from 6.05 per cent to 3 month Euribor plus 2.25 per cent with effect from 23 November 2011.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 44: SUBORDINATED LIABILITIES** continued

With the exception of the two series identified in footnote b below, the ECNs were issued in lower tier 2 format and are convertible into ordinary shares on the breach of a defined trigger. The trigger is if the published core tier 1 ratio of the Group (as defined by the Financial Services Authority in May 2009) falls below 5 per cent.

| | Note | **2013 £m** | 2012 £m |
|---|---|---|---|
| **Enhanced Capital Notes** | | | |
| 7.625% Enhanced Capital Notes due 2019 (£151 million) | | **145** | 144 |
| 8.125% Enhanced Capital Notes due 2019 (£4 million) | | **4** | 4 |
| 9% Enhanced Capital Notes due 2019 (£97 million) | | **102** | 98 |
| 7.8673% Enhanced Capital Notes due 2019 (£331 million) | | **333** | 332 |
| 15% Enhanced Capital Notes due 2019 (£775 million) | | **1,064** | 1,093 |
| 15% Enhanced Capital Notes due 2019 (€487 million) | | **567** | 571 |
| 8.875% Enhanced Capital Notes due 2020 (€125 million) | | **116** | 113 |
| 9.334% Enhanced Capital Notes due 2020 (£208 million) | | **231** | 230 |
| 7.375% Enhanced Capital Notes due 2020 (€95 million) | | **80** | 78 |
| Floating Rate Enhanced Capital Notes due 2020 (€53 million) | a | **37** | 37 |
| 7.875% Enhanced Capital Notes due 2020 (US$408 million) | | **258** | 267 |
| 11.04% Enhanced Capital Notes due 2020 (£736 million) | | **824** | 847 |
| 7.5884% Enhanced Capital Notes due 2020 (£732 million) | | **706** | 703 |
| 6.385% Enhanced Capital Notes due 2020 (€662 million) | | **524** | 493 |
| 6.439% Enhanced Capital Notes due 2020 (€711 million) | | **563** | 542 |
| 8% Fixed to Floating Rate Undated Enhanced Capital Notes callable 2020 (US$1,259 million) | b | **662** | 662 |
| 9.125% Enhanced Capital Notes due 2020 (£148 million) | | **157** | 157 |
| 12.75% Enhanced Capital Notes due 2020 (£57 million) | | **71** | 73 |
| 7.869% Enhanced Capital Notes due 2020 (£597 million) | | **593** | 591 |
| 7.625% Enhanced Capital Notes due 2020 (€226 million) | | **185** | 181 |
| 7.875% Enhanced Capital Notes due 2020 (US$986 million) | | **595** | 608 |
| 11.125% Enhanced Capital Notes due 2020 (£39 million) | | **44** | 44 |
| 8.5% Undated Enhanced Capital Notes callable 2021 (US$277 million) | b | **146** | 147 |
| 14.5% Enhanced Capital Notes due 2022 (£79 million) | | **110** | 113 |
| 9.875% Enhanced Capital Notes due 2023 (£57 million) | | **66** | 66 |
| 11.25% Enhanced Capital Notes due 2023 (£95 million) | | **115** | 113 |
| 10.5% Enhanced Capital Notes due 2023 (£69 million) | | **78** | 76 |
| 11.875% Enhanced Capital Notes due 2024 (£35 million) | | **44** | 45 |
| 7.975% Enhanced Capital Notes due 2024 (£102 million) | | **99** | 99 |
| 16.125% Enhanced Capital Notes due 2024 (£61 million) | | **94** | 95 |
| 15% Enhanced Capital Notes due 2029 (£68 million) | | **108** | 108 |
| 9% Enhanced Capital Notes due 2029 (£107 million) | | **112** | 112 |
| 8.5% Enhanced Capital Notes due 2032 (£104 million) | | **105** | 105 |
| **Total Enhanced Capital Notes** | | **8,938** | 8,947 |

a  Interest is payable quarterly in arrears at a rate of 3 month Euribor plus 3.1 per cent per annum.

b  Issued in upper tier 2 format.
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 44: SUBORDINATED LIABILITIES** continued

| | Note | **2013 £m** | 2012 £m |
|---|---|---|---|
| **Dated subordinated liabilities** | | | |
| Subordinated Step-up Floating Rate Notes 2016 (€500 million) | a | **172** | 172 |
| Subordinated Step-up Floating Rate Notes 2016 (£300 million) | a | **183** | 184 |
| Callable Floating Rate Subordinated Notes 2016 (€500 million) | a | **109** | 96 |
| Callable Floating Rate Subordinated Notes 2016 (€500 million) | a | **156** | 137 |
| Subordinated Callable Notes 2016 (US$750 million) | a | **218** | 198 |
| Subordinated Callable Notes 2017 (€1,000 million) | a | **276** | 243 |
| 6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 (Aus$200 million) | a, b | **5** | 6 |
| Subordinated Callable Floating Rate Instruments 2017 (Aus$400 million) | a | **33** | 38 |
| 5.109% Callable Fixed to Floating Rate Notes 2017 (Can$500 million) | a, c | **10** | 8 |
| Subordinated Callable Notes 2017 (US$1,000 million) | a | **211** | 198 |
| 6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 (£500 million) | a, d | **23** | 21 |
| 6.125% Notes 2013 (€325 million) | | **–** | 280 |
| 5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million) | | **–** | 858 |
| 4.25% Subordinated Guaranteed Notes 2013 (US$1,000 million) | | **–** | 619 |
| 6.45% Fixed to Floating Subordinated Guaranteed Bonds 2023 (€400 million) (Clerical Medical Finance plc) | | **–** | 181 |
| 11% Subordinated Bonds 2014 (£250 million) | | **275** | 284 |
| 5.875% Subordinated Notes 2014 (£150 million) | | **155** | 157 |
| 5.875% Subordinated Guaranteed Bonds 2014 (€750 million) | | **658** | 669 |
| 4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million) | | **621** | 604 |
| 4.875% Subordinated Notes 2015 (€1,000 million) | | **862** | 844 |
| 6.625% Subordinated Notes 2015 (£350 million) | | **371** | 375 |
| 6.9625% Callable Subordinated Fixed to Floating Rate Notes 2020 callable 2015 (£750 million) | | **701** | 716 |
| 11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (€1,147 million) | | **975** | 977 |
| 10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (£466 million) | | **458** | 477 |
| 9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (US$568 million) | | **349** | 360 |
| 10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Can$387 million) | | **223** | 240 |
| 13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Aus$417 million) | | **234** | 280 |
| 10.5% Subordinated Bonds 2018 (£150 million) | | **174** | 177 |
| 6.75% Subordinated Fixed Rate Notes 2018 (US$2,000 million) | | **1,102** | 1,146 |
| 10.375% Subordinated Fixed to Fixed Rate Notes 2024 callable 2019 (€154 million) | | **141** | 143 |
| 6.375% Subordinated Instruments 2019 (£250 million) | | **256** | 281 |
| 6.5% Dated Subordinated Notes 2020 (€1,500 million) | | **1,433** | 1,458 |
| 7.375% Dated Subordinated Notes 2020 | | **3** | 4 |
| 5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million) | | **331** | 371 |
| 6.5% Subordinated Fixed Rate Notes 2020 (US$2,000 million) | | **1,231** | 1,345 |
| Subordinated Floating Rate Notes 2020 (€100 million) | | **85** | 83 |
| 9.375% Subordinated Bonds 2021 (£500 million) | | **617** | 727 |
| 5.374% Subordinated Fixed Rate Notes 2021 (€160 million) | | **147** | 152 |

| | | |
|---|---|---|
| 9.625% Subordinated Bonds 2023 (£300 million) | **341** | 376 |
| 7.07% Subordinated Fixed Rate Notes 2023 (€175 million) | **175** | 183 |
| 5.50% Subordinated Notes 2023 (£850 million) (Scottish Widows plc) | **794** | – |
| 4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million) | **445** | 457 |
| 7.625% Dated Subordinated Notes 2025 (£750 million) | **822** | 915 |
| 6% Subordinated Notes 2033 (US$750 million) | **313** | 399 |
| 7.00% Subordinated Notes 2043 (£650 million) (Scottish Widows plc) | **593** | – |
| **Total dated subordinated liabilities** | **16,281** | 17,439 |

a These securities have passed their first call dates, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval of the PRA.

b The interest rate payable on this security was reset from 6.75 per cent fixed to Bank Bill Swap Rate plus 0.76 per cent with effect from 1 May 2012.

c The interest rate payable on this security was reset from 5.109 per cent fixed to Canadian Dealer Offered Rate plus 0.65 per cent with effect from 21 June 2012.

d The interest rate payable on this security was reset from 6.305 per cent fixed to 3-month Libor plus 1.2 per cent with effect from 18 October 2012.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 45: SHARE CAPITAL**

**(1) AUTHORISED SHARE CAPITAL**

As permitted by the Companies Act 2006, the Company removed references to authorised share capital from its articles of association at the annual general meeting on 5 June 2009. This change took effect from 1 October 2009.

**(2) ISSUED AND FULLY PAID SHARE CAPITAL**

| | **2013 Number of shares** | 2012 Number of shares | 2011 Number of shares | **2013 £m** | 2012 £m | 2011 £m |
|---|---|---|---|---|---|---|
| **Ordinary shares of 10p (formerly 25p) each** | | | | | | |
| At 1 January | **70,342,844,289** | 68,726,627,112 | 68,074,129,454 | **7,034** | 6,873 | 6,807 |
| Issued in relation to the payment of coupons on certain hybrid capital securities | **712,973,022** | 479,297,215 | – | **71** | 47 | – |
| Issued under employee share schemes | **312,618,630** | 1,136,919,962 | 652,497,658 | **32** | 114 | 66 |
| **At 31 December** | **71,368,435,941** | 70,342,844,289 | 68,726,627,112 | **7,137** | 7,034 | 6,873 |
| **Limited voting ordinary shares of 10p (formerly 25p) each** | | | | | | |
| **At 1 January and 31 December** | **80,921,051** | 80,921,051 | 80,921,051 | **8** | 8 | 8 |
| **Total issued share capital** | | | | **7,145** | 7,042 | 6,881 |

**SHARE ISSUANCES**

In 2013 the Group issued 713 million new ordinary shares (2012: 479 million shares; 2011: nil) in relation to payment of coupons in the year on certain hybrid capital securities that are non-cumulative; the remaining 312 million shares issued in 2013 were in respect of employee share schemes (2012: 1,137 million shares; 2011: 652 million shares).

**(3) SHARE CAPITAL AND CONTROL**

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

- certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws);
- pursuant to the UK Listing Authority's listing rules where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and
- pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights.

Information regarding significant direct or indirect holdings of shares in the Company can be found on page 186.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary and preference shares as granted at the annual general meeting on 16 May 2013. The authority to issue shares and the authority to make market purchases of shares will expire at the next annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and entitled to vote has one vote for every share held.

Further details regarding voting at the annual general meeting can be found in the notes to the notice of the annual general meeting.

**ORDINARY SHARES**

The holders of ordinary shares (excluding the limited voting ordinary shares), who held 99.9 per cent of the total ordinary share capital at 31 December 2013, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares (excluding the limited voting ordinary shares) may also receive a dividend (subject to the provisions of the Company's articles of association) and on a winding up may share in the assets of the Company.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 45: SHARE CAPITAL** continued

**LIMITED VOTING ORDINARY SHARES**

The limited voting ordinary shares are held by the Lloyds Bank Foundations (the Foundations). The holders of the limited voting ordinary shares, who held 0.1 per cent of the total ordinary share capital at 31 December 2013, are entitled to receive copies of every circular or other document sent out by the Company to the holders of other ordinary shares. These shares carry no rights to dividends but rank pari passu with the ordinary shares in respect of other distributions and in the event of winding up. These shares do not have any right to vote at general meetings other than on resolutions concerning acquisitions or disposals of such importance that they require shareholder consent, or for the winding up of the Company, or for a variation in the class rights of the limited voting ordinary shares. In the event of an offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting ordinary share will convert into an ordinary share and shall rank equally with the ordinary shares in all respects from the date of conversion.

The Company has entered into deeds of covenant with the Foundations under the terms of which the Company makes annual donations. The deeds of covenant can be cancelled by the Company at nine years notice, at which point the limited voting ordinary shares would convert into ordinary shares. Such notice has been given to the Lloyds Bank Foundation for Scotland.

**PREFERENCE SHARES**

The Company has in issue various classes of preference shares which are all classified as liabilities under IFRS and details of which are shown in note 44.

**NOTE 46: SHARE PREMIUM ACCOUNT**

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| At 1 January | **16,872** | 16,541 | 16,291 |
| Issued in relation to the settlement of coupons on certain hybrid capital securities[1] | **279** | 123 | – |
| Issued under employee share schemes | **128** | 208 | 250 |
| **At 31 December** | **17,279** | 16,872 | 16,541 |

[1] During 2013 the Group issued new ordinary shares for a consideration of £350 million (2012: £170 million; 2011: £nil) in relation to payment of coupons on certain hybrid capital securities that are non-cumulative.

**NOTE 47: OTHER RESERVES**

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Other reserves comprise: | | | |
| Merger reserve | **8,107** | 8,107 | 8,107 |
| Capital redemption reserve | **4,115** | 4,115 | 4,115 |
| Revaluation reserve in respect of available-for-sale financial assets | **(615 )** | 399 | 1,326 |
| Cash flow hedging reserve | **(1,055 )** | 350 | 325 |
| Foreign currency translation reserve | **(75 )** | (69 ) | (55 ) |
| **At 31 December** | **10,477** | 12,902 | 13,818 |

The merger reserve primarily comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

The revaluation reserve in respect of available-for-sale financial assets represents the cumulative after tax unrealised change in the fair value of financial assets classified as available-for-sale since initial recognition; in the case of available-for-sale financial assets obtained on acquisitions of businesses, since the date of acquisition; and in the case of transferred assets that were previously held at amortised cost, by reference to that amortised cost.

The cash flow hedging reserve represents the cumulative after tax gains and losses on effective cash flow hedging instruments that will be reclassified to the income statement in the periods in which the hedged item affects profit or loss.

The foreign currency translation reserve represents the cumulative after-tax gains and losses on the translation of foreign operations and exchange differences arising on financial instruments designated as hedges of the Group's net investment in foreign operations.

Movements in other reserves were as follows:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| **Merger reserve** | | | |
| **At 1 January and 31 December** | **8,107** | 8,107 | 8,107 |

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| **Capital redemption reserve** | | | |
| **At 1 January and 31 December** | **4,115** | 4,115 | 4,115 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 47: OTHER RESERVES** continued

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| **Revaluation reserve in respect of available-for-sale financial assets** | | | |
| At 1 January | **399** | 1,326 | (285 ) |
| Adjustment on transfer from held-to-maturity portfolio | **–** | 1,168 | – |
| Change in fair value of available-for-sale financial assets | **(680 )** | 900 | 2,527 |
| Deferred tax | **86** | (516 ) | (657 ) |
| Current tax | **3** | (3 ) | – |
| | **(591 )** | 1,549 | 1,870 |
| Income statement transfers: | | | |
| Disposals (note 9) | **(629 )** | (3,547) | (343 ) |
| Deferred tax | **191** | 848 | 30 |
| | **(438 )** | (2,699) | (313 ) |
| Impairment | **18** | 42 | 80 |
| Deferred tax | **(3 )** | 12 | 29 |
| | **15** | 54 | 109 |
| Other transfers | **–** | 169 | (79 ) |
| Deferred tax | **–** | – | 24 |
| | **–** | 169 | (55 ) |
| **At 31 December** | **(615 )** | 399 | 1,326 |

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| **Cash flow hedging reserve** | | | |
| At 1 January | **350** | 325 | (391 ) |
| Change in fair value of hedging derivatives | **(1,229)** | 116 | 916 |
| Deferred tax | **320** | (17 ) | (257 ) |
| Current tax | **–** | – | – |
| | **(909 )** | 99 | 659 |
| Income statement transfers (note 5) | **(550 )** | (92 ) | 70 |
| Deferred tax | **54** | 18 | (13 ) |
| | **(496 )** | (74 ) | 57 |
| **At 31 December** | **(1,055)** | 350 | 325 |

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| **Foreign currency translation reserve** | | | |
| At 1 January | **(69 )** | (55 ) | 29 |
| Currency translation differences arising in the year | **(155 )** | (69 ) | (58 ) |
| Foreign currency gains (losses) on net investment hedges (tax: £nil) | **149** | 55 | (26 ) |
| **At 31 December** | **(75 )** | (69 ) | (55 ) |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 48: RETAINED PROFITS**

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| At 1 January | | | |
| As previously reported | | | 9,044 |
| Restatement (notes 1 and 56) | | | (707 ) |
| Restated | **5,080** | 8,266 | 8,337 |
| Profit (loss) for the year | **(838 )** | (1,471) | (627 ) |
| Post-retirement defined benefit scheme remeasurements | **(108 )** | (1,645) | 469 |
| Movement in treasury shares | **(480 )** | (407 ) | (276 ) |
| Value of employee services: | | | |
| Share option schemes | **142** | 81 | 125 |
| Other employee award schemes | **292** | 256 | 238 |
| **At 31 December** | **4,088** | 5,080 | 8,266 |

Retained profits are stated after deducting £480 million (2012: £158 million; 2011: £33 million) representing 578 million (2012: 301 million; 2011: 58 million) treasury shares held.

**NOTE 49: ORDINARY DIVIDENDS**

No dividends were paid on ordinary shares during 2011, 2012 or 2013 and the directors do not propose to pay a final dividend in respect of 2013.

The trustees of the following holdings of Lloyds Banking Group plc shares in relation to employee share schemes retain the right to receive dividends but have chosen to waive their entitlement to the dividends on those shares as indicated: the Lloyds Banking Group Share Incentive Plan (holding at 31 December 2013: 16,857,069 shares, 31 December 2012: 12,040,715 shares, waived rights to all dividends), the Lloyds TSB Group Employee Share Ownership Trust (holding at 31 December 2013: 52,150,441 shares, 31 December 2012: 73,007,743 shares, on which it waived rights to all dividends), Lloyds Group Holdings (Jersey) Limited (holding at 31 December 2013: 42,846 shares, 31 December 2012: 42,846 shares, waived rights to all but a nominal amount of one penny in total) and the Lloyds TSB Qualifying Employee Share Ownership Trust (holding at 31 December 2013: 1,398 shares, 31 December 2012: 1,398 shares, waived rights to all but a nominal amount of one penny in total).

**NOTE 50: SHARE-BASED PAYMENTS**

**CHARGE TO THE INCOME STATEMENT**

The charge to the income statement is set out below:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Deferred bonus plan | **276** | 248 | 221 |
| Executive and SAYE plans: | | | |
| Options granted in the year | **42** | 12 | 13 |
| Options granted in prior years | **74** | 65 | 130 |
| | **116** | 77 | 143 |
| Share plans: | | | |
| Shares granted in the year | **3** | 3 | 3 |
| Shares granted in prior years | **4** | 5 | 9 |
| | **7** | 8 | 12 |
| **Total charge to the income statement** | **399** | 333 | 376 |

During the year ended 31 December 2013 the Group operated the following share-based payment schemes, all of which are equity settled.

**DEFERRED BONUS PLANS**

Bonuses in respect of the performance in 2013 of employees within certain of the Group’s bonus plans have been recognised in these financial statements in full. The amounts to be settled in shares are included within the total charge to the income statement detailed above.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

**LLOYDS BANKING GROUP EXECUTIVE SHARE OPTION SCHEMES**

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between March 2004 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5.

**PERFORMANCE CONDITIONS FOR EXECUTIVE OPTIONS**

FOR OPTIONS GRANTED IN 2004

The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

To meet the performance conditions, the Group's ranking against the comparator group was required to be at least ninth. The full grant of options only became exercisable if the Group was ranked first. A performance multiplier (of between nil and 100 per cent) was applied below this level to calculate the number of shares in respect of which options granted to Executive Directors would become exercisable, and were calculated on a sliding scale. If Lloyds Banking Group plc was ranked below median the options would not be exercisable.

Options granted to senior executives other than Executive Directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 14 per cent for Executive Directors, 24 per cent for Managing Directors, and 100 per cent for all other executives.

FOR OPTIONS GRANTED IN 2005

The same conditions applied as for grants made in 2004, except that:

- the performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- if the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- the full grant of options became exercisable only if the Group was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group was ranked below the median (ninth or below) the options would lapse.

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.

Movements in the number of share options outstanding under the executive share option schemes during 2012 and 2013 are set out below:

| | **2013** | | 2012 | |
|---|---|---|---|---|
| | **Number of options** | **Weighted average exercise price (pence)** | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | 8,044,896 | 224.95 | 10,174,869 | 225.15 |
| Forfeited | (1,992,303) | 227.70 | (2,129,973 ) | 225.92 |
| Lapsed | – | – | – | – |
| Outstanding at 31 December | 6,052,593 | 224.04 | 8,044,896 | 224.95 |
| Exercisable at 31 December | 6,052,593 | 224.03 | 8,044,896 | 224.95 |

No options were exercised during 2013 or 2012. The weighted average remaining contractual life of options outstanding at the end of the year was 0.8 years (2012: 1.9 years). The fair values of the executive share options have been determined using a standard Black-Scholes model.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

**SAVE-AS-YOU-EARN SCHEMES**

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £250 per month and, at the expiry of a fixed term of three, five or seven years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

Movements in the number of share options outstanding under the SAYE schemes are set out below:

| | **2013** | | 2012 | |
|---|---|---|---|---|
| | **Number of options** | **Weighted average exercise price (pence)** | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **314,572,023** | **48.01** | 453,019,032 | 49.74 |
| Granted | **510,414,399** | **40.62** | – | – |
| Exercised | **(294,905,606)** | **46.78** | – | – |
| Forfeited | **(7,715,717 )** | **43.08** | (8,427,262 ) | 49.15 |
| Cancelled | **(10,761,588 )** | **45.61** | (88,340,810 ) | 49.83 |
| Expired | **(10,633,894 )** | **56.28** | (41,678,937 ) | 62.67 |
| Outstanding at 31 December | **500,969,617** | **41.16** | 314,572,023 | 48.01 |
| Exercisable at 31 December | **2,255,239** | **120.76** | 119,141 | 86.50 |

The weighted average share price at the time that the options were exercised during 2013 was £0.65. No options were exercised in 2012. The weighted average remaining contractual life of options outstanding at the end of the year was 2.9 years (2012: 0.8 years).

The weighted average fair value of SAYE options granted during 2013 was £0.24. No options were granted in 2012. The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2013 or 2012. The options outstanding at 31 December 2013 had an exercise price of £1.8066 (2012: £1.8066) and a weighted average remaining contractual life of 1.1 years (2012: 2.1 years).

**OTHER SHARE OPTION PLANS**

**LLOYDS BANKING GROUP EXECUTIVE SHARE PLAN 2003**

The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan’s usage has now been extended to not only compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

Participants are not entitled to any dividends paid during the vesting period.

| | **2013** | | 2012 | |
|---|---|---|---|---|
| | **Number of options** | **Weighted average exercise price (pence)** | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **45,614,150** | **Nil** | 53,000,069 | Nil |
| Granted | **9,284,956** | **Nil** | 34,345,366 | Nil |
| Exercised | **(16,079,222)** | **Nil** | (41,290,412) | Nil |
| Forfeited | **(1,290,720)** | **Nil** | (440,873) | Nil |
| Lapsed | **(174,185)** | **Nil** | – | Nil |
| Outstanding at 31 December | **37,354,979** | **Nil** | 45,614,150 | Nil |
| Exercisable at 31 December | **4,275,432** | **Nil** | 3,065,531 | Nil |

The weighted average fair value of options granted in the year was £0.56 (2012: £0.30). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2013 was £0.55 (2012: £0.33). The weighted average remaining contractual life of options outstanding at the end of the year was 3.6 years (2012: 3.7 years).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

**LLOYDS BANKING GROUP SHARE BUY OUT AWARDS**

As part of arrangements to facilitate the recruitment of certain Executives, options have been granted by individual deed and, where appropriate, in accordance with the Listing Rules of the UK Listing Authority.

The awards were granted in recognition that the Executives' outstanding awards over shares in their previous employing company lapsed on accepting employment with the Group.

Movements in the number of options outstanding are set out below:

| | **2013** | | 2012 | |
|---|---|---|---|---|
| | **Number of options** | **Weighted average exercise price (pence)** | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **21,321,237** | **Nil** | 21,321,237 | Nil |
| Granted | **–** | **–** | – | – |
| Exercised | **(5,953,810 )** | **Nil** | – | – |
| Forfeited | **(4,194,827 )** | **Nil** | – | – |
| Outstanding at 31 December | **11,172,600** | **Nil** | 21,321,237 | Nil |
| Exercisable at 31 December | **11,083,749** | **Nil** | 16,509,862 | Nil |

No options were granted in 2013 or 2012. The weighted average remaining contractual life of options outstanding at the end of the year was 7.5 years (2012: 8.6 years).

The weighted average share price at the time the options were exercised during 2013 was £0.75. No options were exercised in 2012.

Participants are entitled to any dividends paid during the vesting period. This amount will be paid in cash unless the Remuneration Committee decides it will be paid in shares.

The fair values of the majority of options granted have been determined using a standard Black-Scholes model. The fair values of the remaining options have been determined by Monte Carlo simulation.

**HBOS SHARE OPTION PLANS**

The table below details the outstanding options for the HBOS Share Option Plan and the St James's Place Share Option Plan. The final award under the HBOS Share Option Plan was made in 2004. Under this plan, options over shares, at market value with a face value equal to 20 per cent of salary, were granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which granted options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:

During 2013 the Group completed the sale of all of its holding in St James's Place plc, as set out in note 9. The participants of the St James's Place Share Option Plan remain entitled to the Lloyds Banking Group plc shares awarded under the terms of this Plan and these options are included in the table below.

Participants are not entitled to any dividends paid during the vesting period.

| | **2013** | | 2012 | |
|---|---|---|---|---|
| | **Number of options** | **Weighted average exercise price (pence)** | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **19,857,692** | **363.76** | 22,058,552 | 394.30 |
| Exercised | **(2,609,272 )** | **51.83** | – | – |
| Forfeited | **(240,349 )** | **568.80** | (319,134 ) | 572.22 |
| Lapsed | **(2,144,026 )** | **546.43** | (1,881,726 ) | 686.47 |
| Cancelled | **(1,744,461 )** | **532.39** | – | – |
| Outstanding at 31 December | **13,119,584** | **369.76** | 19,857,692 | 363.76 |
| Exercisable at 31 December | **13,119,584** | **369.76** | 19,857,692 | 363.76 |

The weighted average share price at the time the options were exercised during 2013 was £0.72. No options were exercised in 2012.

The options outstanding under the HBOS Share Option Plan and St James's Place Share Option Plan at 31 December 2013 had exercise prices in the range of £0.5183 to £5.80 (2012: £0.5183 to £5.80) and a weighted average remaining contractual life of 0.2 years (2012: 1.1 years).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

**OTHER SHARE PLANS**

**LLOYDS BANKING GROUP LONG-TERM INCENTIVE PLAN**

The Long-Term Incentive Plan (LTIP) introduced in 2006 is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Group over a three year period. Awards are made within limits set by the rules of the Plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares.

The performance conditions for awards made in March and August 2010 were as follows:

(i) **EPS:** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2009.

If the absolute improvement in adjusted EPS reached 158 per cent, 25 per cent of this element of the award, being the threshold, would vest. If absolute improvement in adjusted EPS reached 180 per cent, 100 per cent of this element would vest.

Vesting between threshold and maximum would be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. Performance was measured based on the compound annual growth rate of adjusted EP over the three financial years starting on 1 January 2010 relative to an adjusted 2009 EP base.

If the compounded annual growth rate of adjusted EP reached 57 per cent per annum, 25 per cent of this element of the award, being the threshold, would vest. If the compounded annual growth rate of adjusted EP reached 77 per cent per annum, 100 per cent of this element would vest.

Vesting between threshold and maximum would be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Share Price, relevant to 28 per cent of the award. Performance was measured based on the Absolute Share Price on 26 March 2013, being the third anniversary of the award date. If the share price at the end of the performance period was 75 pence or less, none of this element of the award would vest. If the share price was 114 pence or higher, 100 per cent of this element would vest. Vesting between threshold and maximum would be on a straight line basis, provided that shares comprised in the Absolute Share Price element may only be released if both the EPS and EP performance measures had been satisfied at the threshold level or above. The EPS and EP performance conditions each relate to 36 per cent of the total award.

At the end of the performance period for the EPS and EP measures, it was assessed that neither of the performance conditions had been met and the awards did not vest.

The performance conditions for awards made in March and September 2011 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EPS outcome.

If the adjusted EPS reaches 6.4p, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted EPS reaches 7.8p, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EP outcome.

If the adjusted EP reaches £567 million, 25 per cent of this element of the award, being the threshold, will vest. If the adjusted EP reaches £1,534 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Total Shareholder Return, relevant to one third of the award. Performance will be measured based on the annualised Absolute Total Shareholder Return over the three year performance period. If the annualised Absolute Total Shareholder Return at the end of the performance period is less than 8 per cent, none of this element of the award will vest. If the Absolute Total Shareholder Return is 8 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the Absolute Total Shareholder Return is 14 per cent or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis. The EPS and EP performance conditions will each relate to 33.3 per cent of the total award.

At the end of the performance period for the EPS and EP measures, the targets had not been fully met and therefore those awards will vest in 2014 at a rate of 68 per cent (54 per cent for members of the Group Executive Committee, including Executive Directors).

The performance conditions for awards made in March and September 2012 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2014 adjusted EP outcome.

If the adjusted EP reaches £225 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £2,330 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

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**NOTE 50: SHARE-BASED PAYMENTS** continued

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

If the ATSR reaches 12 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 30 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iii) **Short-term funding as a percentage of total funding:** relevant to 10 per cent of the award. Performance will be measured relative to 2014 targets.
If the average percentage reaches 20 per cent, 25 per cent of this element of the award, being the threshold, will vest.

If the average percentage reaches 15 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **The level of assets at the end of 2014 which are outside of the Group's risk appetite:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet assets (excluding UK Retail) at 31 December 2014.

If such assets amount to £95 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If such assets amount to £80 billion or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **Net Simplification benefits:** relevant to 10 per cent of the award. Performance will be measured by reference to the run rate achieved by the end of 2014.

If a run rate of net Simplification benefits of £1.5 billion is achieved, 25 per cent of this element of the award, being the threshold, will vest.

If a run rate of net Simplification benefits of £1.8 billion is achieved, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(vi) **Customer satisfaction:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers over the three year period to 31 December 2014.

If complaints per 1,000 customers average 1.5 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 1.3 per annum or less over three years, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

The performance conditions for awards made in March and October 2013 are as follows:

(i) **EP:** relevant to 35 per cent of the award. The performance target is based on 2015 adjusted EP outcome.

If the adjusted EP reaches £1,254 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £1,881 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2015.

If the ATSR reaches 8 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 16 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iii) **Adjusted total costs:** relevant to 10 per cent of the award. The performance target is based on 2015 adjusted total costs.

If adjusted total costs are £9,323 million or less, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted total costs are £8,973 million or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **The level of assets at the end of 2014 which are outside of the Group's risk appetite (excluding UK Retail) at the end of 2015:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet assets at 31 December 2015.

If such assets amount to £37 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If such assets amount to £28 billion or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **Customer satisfaction:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FCA reportable complaints per 1,000 customers over the three year period to 31 December 2015.

If complaints per 1,000 customers average 1.05 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 0.95 per annum or less over three years, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(vi) **SME lending:** relevant to 5 per cent of the award. Performance will be measured by reference to the movement in lending to SMEs relative to the market as reported by the Bank of England over the three year period ending 31 December 2015.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

If the movement in SME lending equates to this market movement, 25 per cent of this element of the award, being the threshold, will vest.

If the movement in SME lending is 4 per cent or more greater than the market movement, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

In addition, short-term funding must remain within that stated in the Group's Risk Appetite throughout the three year period to 31 December 2015.

| | **2013 Number of shares** | 2012 Number of shares |
|---|---|---|
| Outstanding at 1 January | **515,951,517** | 543,738,186 |
| Granted | **186,360,995** | 265,011,679 |
| Vested | **–** | (71,591,014) |
| Forfeited | **(153,426,617)** | (221,207,334) |
| Outstanding at 31 December | **548,885,895** | 515,951,517 |

The weighted average fair value of the share awards granted in 2013 was £0.34 (2012: £0.24). The fair values of the majority of share awards granted have been determined using a standard Black-Scholes model. The fair values of the remaining share awards have been determined by Monte Carlo simulation.

**SCOTTISH WIDOWS INVESTMENT PARTNERSHIP LONG-TERM INCENTIVE PLAN**

The Scottish Widows Investment Partnership (SWIP) Long-Term Incentive Plan applicable to senior executives and employees of SWIP, which had previously been a cash-only scheme, was amended in May 2012 for awards granted on or after that date. The amendment introduced the receipt of shares in Lloyds Banking Group plc as an element of the total award. For awards made in June 2012, the other element continued to be cash-based, with the split between cash-based and share-based determined by the Remuneration Committee. Awards made in June 2013 were fully share-based. The amendment is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of SWIP over a three year period. Awards are made within limits set by the rules of the Plan, with the maximum limits for combined cash and shares awarded equating to 3.5 times annual salary. In exceptional circumstances this may increase to 4 times annual salary.

The performance conditions for share-based awards made in June 2012 are as follows:

(i) **Profitability:** relevant to 40 per cent of the award. The performance target is based on a cumulative 3 year profit before tax. If cumulative profit before tax reaches a specified target level, 100 per cent of this element will vest. If cumulative profit before tax reaches 90 per cent of the target level, 25 per cent of this element of the award, being the threshold, will vest. If cumulative profit before tax reaches 110 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(ii) **Investment performance:** relevant to 40 per cent of the award. The performance target is based on the percentage of SWIP funds achieving at or above benchmark performance (on a competitor median or index basis) over the 3 year period. If 50 per cent of funds exceed benchmark performance, 25 per cent of this element of the award, being the threshold, will vest. If 55 per cent of funds exceed benchmark performance, 100 per cent of this element, being the target, will vest. If 70 per cent of funds exceed benchmark performance, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(iii) **Funds under management (FUM) growth:** relevant to 20 per cent of the award. The performance target is based on growth in the value of third party assets managed by SWIP by the end of the 3 year period. If third party FUM reaches a specified target level, 100 per cent of this element of the award will vest. If third party FUM reaches 80 per cent of the target level, 25 per cent of this element, being the threshold, will vest. If third party FUM reaches 120 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

For awards made to SWIP's Code Staff (as defined by FSA), a fourth performance condition was set, relating to an internal measure of operational risk. This additional measure is relevant to 15 per cent of the award for these individuals, with a corresponding 5 per cent reduction in each of the weightings for the other three measures described above. As with the other measures, this performance condition has a target value at which 100 per cent of the award will vest, a maximum value at which 200 per cent of the award will vest, and a threshold value at which 25 per cent of the award will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

The relevant period commenced on 1 January 2012 and ends on 31 December 2014.

The performance conditions for share-based awards made in June 2013 are as follows:

(i) **Profitability:** relevant to 35 per cent of the award. The performance target is based on a cumulative 3 year profit before tax. If cumulative profit before tax reaches a specified target level, 100 per cent of this element will vest. If cumulative profit before tax reaches 80 per cent of the target level, 25 per cent of this element of the award, being the threshold, will vest. If cumulative profit before tax reaches 120 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

(ii) **Investment performance:** relevant to 35 per cent of the award. The performance target is based on the percentage of SWIP funds achieving at or above benchmark performance (on a competitor median or index basis) over the 3 year period. If 50 per cent of funds exceed benchmark performance, 25 per cent of this element of the award, being the threshold, will vest. If 55 per cent of funds exceed benchmark performance, 100 per cent of this element, being the target, will vest. If 70 per cent of funds exceed benchmark performance, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(iii) **Funds under management (FUM) growth:** relevant to 15 per cent of the award. The performance target is based on growth in the value of third party assets managed by SWIP by the end of the 3 year period. If third party FUM reaches a specified target level, 100 per cent of this element of the award will vest. If third party FUM reaches 80 per cent of the target level, 25 per cent of this element, being the threshold, will vest. If third party FUM reaches 120 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(iv) **Risk:** relevant to 15 per cent of the award. The performance target is based on a cumulative three year risk score. If the cumulative risk score reaches a specified target level, 100 per cent of this element will vest. If the cumulative risk score reaches 120 per cent of the target level, 25 per cent of this element of the award, being the threshhold, will vest. If the cumulative risk score is 80 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

The relevant period commenced on 1 January 2013 and ends on 31 December 2015.

| | **2013 Number of shares** | 2012 Number of shares |
|---|---|---|
| Outstanding at 1 January | **5,452,877** | – |
| Granted | **10,331,924** | 5,452,877 |
| Outstanding at 31 December | **15,784,801** | 5,452,877 |

The fair value of the share awards granted in 2013 was £0.43. The fair values of share awards granted have been determined using a standard Black-Scholes model.

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

| | **Executive schemes** | | | **SAYE schemes** | | | **Other share option plans** | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Weighted average exercise price (pence)** | **Weighted average remaining life (years)** | **Number of options** | **Weighted average exercise price (pence)** | **Weighted average remaining life (years)** | **Number of options** | **Weighted average exercise price (pence)** | **Weighted average remaining life (years)** | **Number of options** |
| At 31 December 2013 | | | | | | | | | |
| Exercise price range | | | | | | | | | |
| £0 to £1 | – | – | – | 40.63 | 2.91 | 499,088,383 | 5.25 | 4.1 | 51,528,728 |
| £1 to £2 | 199.91 | 0.6 | 196,201 | 180.64 | 1.09 | 1,881,234 | – | – | – |
| £2 to £3 | 224.85 | 0.8 | 5,856,392 | – | – | – | – | – | – |
| £5 to £6 | – | – | – | – | – | – | 580.00 | 0.2 | 7,897,324 |

| | Executive schemes | | | SAYE schemes | | | Other share option plans | | |
|---|---|---|---|---|---|---|---|---|---|
| | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options |
| At 31 December 2012 | | | | | | | | | |
| Exercise price range | | | | | | | | | |
| £0 to £1 | – | – | – | 46.79 | 0.8 | 311,648,405 | 5.43 | 4.9 | 74,766,919 |
| £1 to £2 | 199.91 | 1.6 | 233,714 | 178.14 | 1.8 | 2,923,618 | – | – | – |
| £2 to £3 | 225.69 | 1.9 | 7,811,182 | – | – | – | – | – | – |
| £3 to £4 | – | – | – | – | – | – | – | – | – |
| £5 to £6 | – | – | – | – | – | – | 566.89 | 0.9 | 12,026,160 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 50: SHARE-BASED PAYMENTS** continued

The fair value calculations at 31 December 2013 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

| | **Save-As-You-Earn** | **Executive Share Plan 2003** | **LTIP** | **SWIP LTIP** |
|---|---|---|---|---|
| Weighted average risk-free interest rate | 0.33% | 0.37% | 0.31% | 0.30% |
| Weighted average expected life | 3.1 years | 1.0 years | 3.0 years | 3.0 years |
| Weighted average expected volatility | 45% | 35% | 45% | 45% |
| Weighted average expected dividend yield | 2.5% | 2.5% | 4.3% | 4.4% |
| Weighted average share price | £0.51 | £0.57 | £0.49 | £0.49 |
| Weighted average exercise price | £0.41 | Nil | Nil | Nil |

Expected volatility is a measure of the amount by which the Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

**SHARE INCENTIVE PLAN**

**FREE SHARES**

An award of shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to a maximum of £3,000. The percentage is normally announced concurrently with the Group's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves the Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

The last award of free shares was made in 2008.

**MATCHING SHARES**

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2013 was 19,870,495 (2012: 36,158,343), with an average fair value of £0.63 (2012: £0.34), based on market prices at the date of award.

**NOTE 51: RELATED PARTY TRANSACTIONS**

**KEY MANAGEMENT PERSONNEL**

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

The table below details, on an aggregated basis, key management personnel compensation:

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Compensation | | | |
| Salaries and other short-term benefits | **15** | 12 | 12 |
| Post-employment benefits | **–** | – | – |
| Share-based payments | **21** | 13 | 11 |
| Total compensation | **36** | 25 | 23 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 51: RELATED PARTY TRANSACTIONS** continued

Aggregate contributions in respect of key management personnel to defined contribution pension schemes were £0.2 million (2012: £0.1 million; 2011: £0.2 million).

| | **2013 million** | 2012 million | 2011 million |
|---|---|---|---|
| Share option plans | | | |
| At 1 January | **25** | 22 | 6 |
| Granted, including certain adjustments[1] (includes entitlements of appointed key management personnel) | **5** | 8 | 20 |
| Exercised/lapsed (includes entitlements of former key management personnel) | **(16)** | (5) | (4) |
| At 31 December | **14** | 25 | 22 |

[1] 2010 includes adjustments, using a standard HMRC formula, to negate the dilutionary impact of the Group's 2009 capital raising activities.

| | **2013 million** | 2012 million | 2011 million |
|---|---|---|---|
| Share plans | | | |
| At 1 January | **70** | 58 | 56 |
| Granted, including certain adjustments[1] (includes entitlements of appointed key management personnel) | **42** | 45 | 35 |
| Exercised/lapsed (includes entitlements of former key management personnel) | **(7)** | (33) | (33) |
| At 31 December | **105** | 70 | 58 |

[1] 2010 includes adjustments, using a standard HMRC formula, to negate the dilutionary impact of the Group's 2009 capital raising activities.

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Group and its key management personnel:

| | **2013 £m** | 2012 £m | 2011 £m |
|---|---|---|---|
| Loans | | | |
| At 1 January | **2** | 3 | 3 |
| Advanced (includes loans of appointed key management personnel) | **2** | 3 | 1 |

| | | | |
|---|---|---|---|
| Repayments (includes loans of former key management personnel) | **(2 )** | (4 ) | (1 ) |
| At 31 December | **2** | 2 | 3 |

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 2.5 per cent and 23.9 per cent in 2013 (2012: 2.5 per cent and 29.95 per cent; 2011: 1.09 per cent and 27.5 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2012 and 2011: £nil).

| | **2013** | 2012 | 2011 |
|---|---|---|---|
| | **£m** | £m | £m |
| Deposits | | | |
| At 1 January | **10** | 6 | 4 |
| Placed (includes deposits of appointed key management personnel) | **29** | 39 | 17 |
| Withdrawn (includes deposits of former key management personnel) | **(26 )** | (35 ) | (15 ) |
| At 31 December | **13** | 10 | 6 |

Deposits placed by key management personnel attracted interest rates of up to 2.9 per cent (2012: 3.8 per cent; 2011: 5 per cent).

At 31 December 2013, the Group did not provide any guarantees in respect of key management personnel (2012 and 2011: none).

At 31 December 2013, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £1 million with six directors and five connected persons (2012: £1 million with five directors and three connected persons; 2011: £3 million with four directors and three connected persons).

**SUBSIDIARIES**

Details of the principal subsidiaries are given in note 9 to the parent company financial statements. In accordance with IFRS 10 *Consolidated financial statements*, transactions and balances with subsidiaries have been eliminated on consolidation.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 51: RELATED PARTY TRANSACTIONS** continued

**UK GOVERNMENT**

In January 2009, the UK Government through HM Treasury became a related party of the Company following its subscription for ordinary shares issued under a placing and open offer. At 31 December 2013, HM Treasury held a 32.7 per cent interest in the Company's ordinary share capital and consequently HM Treasury remained a related party of the Company during the year ended 31 December 2013; this percentage holding has reduced from 39.2 per cent at 31 December 2012 following the UK Government's sale of 4,282 million shares on 17 September 2013 and the impact of issues of ordinary shares.

From 1 January 2011, in accordance with IAS 24, UK Government-controlled entities became related parties of the Group. The Group regards the Bank of England and entities controlled by the UK Government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

Since 31 December 2011, the Group has had the following significant transactions with the UK Government or UK Government-related entities:

During the year ended 31 December 2013, the Group participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

**NATIONAL LOAN GUARANTEE SCHEME**

The Group has participated in the UK Government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Group is providing eligible UK businesses with discounted funding, subject to continuation of the scheme and its financial benefits, and based on the Group's existing lending criteria. Eligible businesses who have taken up the funding benefit from a 1 per cent discount on their funding rate for a certain period of time.

**BUSINESS GROWTH FUND**

In May 2011 the Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to commit up to £300 million of equity investment by subscribing for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010. At 31 December 2013, the Group had invested £64 million (31 December 2012: £50 million) in the Business Growth Fund and carried the investment at a fair value of £52 million (31 December 2012: £44 million).

**BIG SOCIETY CAPITAL**

In January 2012 the Group agreed, together with The Royal Bank of Scotland plc (and two other non-related parties), to commit up to £50 million each of equity investment into the Big Society Capital Fund. The Fund, which was created as part of the Project Merlin arrangements, is a UK social investment fund. The Fund was officially launched on 3 April 2012 and the Group had invested £12 million in the Fund by 31 December 2012 and invested a further £11 million during the year ended 31 December 2013.

**FUNDING FOR LENDING**

In August 2012, the Group announced its support for the UK Government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Group. The initiative supports a broad range of UK based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. In November 2013, the Group entered into extension letters with the Bank of England to take part in the extension of the Funding for Lending Scheme until the end of January 2015. The extension of the Funding for Lending Scheme focuses on providing businesses with cheaper finance to invest and grow. At 31 December 2013, the Group had drawn down £8.0 billion under the Funding for Lending Scheme. A further £2.2 billion was drawn in January 2014, which under the Funding for Lending rules counts as funding from the 2013 scheme capacity. This figure includes £0.2 billion drawn by Sainsbury's Bank plc. As a result of the Group's holding in the joint venture, Sainsbury's Bank plc is part of the Group for Funding for Lending purposes for the period to 31 January 2014.

**HELP TO BUY**

On 7 October 2013, Bank of Scotland plc entered into an agreement with The Commissioners of Her Majesty's Treasury by which it agreed that the Halifax Division of Bank of Scotland plc would participate in the Help to Buy Scheme with effect from 11 October 2013 and that Lloyds Bank plc would participate from 3 January 2014. The Help to Buy Scheme is a scheme promoted by the Government and is aimed to encourage participating lenders to make mortgage loans available to customers who require higher loan-to-value mortgages. Halifax and Lloyds are currently participating in the Scheme whereby customers borrow between 90 per cent and 95 per cent of the purchase price.

In return for the payment of a commercial fee, HM Treasury has agreed to provide a guarantee to the lender to cover a proportion of any loss made by the lender arising from a higher loan-to-value loan being made. By 31 December 2013, £79 million had been advanced under this scheme.

**CENTRAL BANK FACILITIES**

In the ordinary course of business, the Group may from time to time access market-wide facilities provided by central banks.

**OTHER GOVERNMENT-RELATED ENTITIES**

Other than the transactions referred to above, there were no other significant transactions with the UK Government and UK Government-controlled entities (including UK Government-controlled banks) during the period that were not made in the ordinary course of business or that were unusual in their nature or conditions.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 51: RELATED PARTY TRANSACTIONS** continued

**OTHER RELATED PARTY TRANSACTIONS**

**SALE OF CERTAIN SECURITISATION NOTES**

During the year ended 31 December 2013, the Group sold at fair value certain securitisation notes to Lloyds Bank Pension Trust (No. 1) Limited for a consideration of approximately £340 million. Following the sale, the Group deconsolidated the relevant securitisation entities recognising a profit of £236 million.

Subsequently, the Group entered into a commercially negotiated agreement with Lloyds Bank Pension Trust (No.1) Limited to jointly sell a portfolio of US Residential Mortgage-Backed Securities with a book value of £3.5 billion. As a result of selling the portfolio together a price premium was achieved compared to selling the notes separately. Under the terms of the agreement the Group and Lloyds Bank Pension Trust (No.1) Limited agreed to share any price premium achieved above an agreed minimum threshold amount. The joint sale resulted in the Group realising a total pre-tax gain of approximately £538 million, of which £99 million related to the premium sharing agreement.

**ST. JAMES'S PLACE PLC**

In March 2013 the Group sold 102 million shares in St. James's Place plc; fees totalling some £5 million in relation to the sale were settled by St. James's Place plc.

**PENSION FUNDS**

The Group provides banking and some investment management services to certain of its pension funds. At 31 December 2013, customer deposits of £145 million (2012: £129 million) and investment and insurance contract liabilities of £4,728 million (2012: £4,569 million (restated)) related to the Group's pension funds.

**COLLECTIVE INVESTMENT VEHICLES**

The Group manages 210 (2012: 244) collective investment vehicles, such as Open Ended Investment Companies (OEICs) and of these 145 (2012: 136) are consolidated. The Group invested £2,472 million (2012: £1,563 million) and redeemed £2,189 million (2012: £1,690 million) in the unconsolidated collective investment vehicles during the year and had investments, at fair value, of £3,291 million (2012: £6,479 million) at 31 December. The Group earned fees of £277 million from the unconsolidated collective investment vehicles during 2013 (2012: £325 million).

**JOINT VENTURES AND ASSOCIATES**

The Group provides both administration and processing services to its principal joint venture, Sainsbury's Bank plc. The amounts receivable by the Group during the year were £35 million (2012: £32 million), of which £10 million was outstanding at 31 December 2013 (2012: £16 million). At 31 December 2013, Sainsbury's Bank plc also had balances with the Group that were included in loans and advances to banks of £806 million (2012: £1,299 million) and deposits by banks of £927 million (2012: £1,268 million).

At 31 December 2013 there were loans and advances to customers of £4,448 million (2012: £3,424 million) outstanding and balances within customer deposits of £70 million (2012: £45 million) relating to other joint ventures and associates.

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2013, these companies had total assets of approximately £6,913 million (2012: £10,759 million), total liabilities of approximately £7,084 million (2012: £10,956 million) and for the year ended 31 December 2013 had turnover of approximately £6,989 million (2012: £8,169 million) and made a net loss of approximately £16 million (2012: net loss of £488 million). In addition, the Group has provided £3,355 million (2012: £5,146 million) of financing to these companies on which it received £170 million (2012: £208 million) of interest income in the year.

**NOTE 52: CONTINGENT LIABILITIES AND COMMITMENTS**

**INTERCHANGE FEES**

On 24 May 2012, the General Court of the European Union (the General Court) upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback multilateral interchange fee (MIF) in respect of cross border transactions in relation to the use of a MasterCard or Maestro branded payment card.

MasterCard has appealed the General Court's judgment to the Court of Justice of the European Union. MasterCard is supported by several card issuers, including the Group. Judgment is not expected until the summer of 2014 or later.

In parallel:

- the European Commission is also considering further action, and has proposed legislation to regulate interchange fees, following its 2012 Green Paper (Towards an integrated European market for cards, internet and mobile payments) consultation;

- the European Commission has consulted on commitments proposed by VISA to settle an investigation into whether arrangements adopted by VISA for the levying of the MIF in respect of cross-border credit card payment transactions also infringe European Union competition laws. VISA has proposed inter alia to reduce the level of interchange fees on cross-border credit card transactions to the interim level (30 basis points) also agreed by MasterCard. VISA has previously reached an agreement (which expires in 2014) with the European Commission to reduce the level of interchange fees for cross-border debit card transactions to the interim levels agreed by MasterCard;

- the Office of Fair Trading (OFT) has placed on hold its examination of whether the levels of interchange fees paid by retailers in respect of MasterCard and VISA credit cards, debit cards and charge cards in the UK infringe competition law. The OFT has placed the investigation on hold pending the outcome of the MasterCard appeal to the Court of Justice of the European Union; and

- the UK Government held a consultation in 2013, Opening Up UK Payments. The consultation included a proposal to legislate to introduce a new economic regulator with responsibility for payment systems, including three and four party card schemes, and a role in setting or approving interchange fees.

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**NOTE 52: CONTINGENT LIABILITIES AND COMMITMENTS** continued

The ultimate impact of the investigations and any regulatory or legislative developments on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings and once regulatory or legislative proposals are more certain.

**INVESTIGATIONS AND LITIGATION RELATING TO INTERBANK OFFERED RATES, AND OTHER REFERENCE RATES**

A number of government agencies in the UK, US and elsewhere, including the UK Financial Conduct Authority, the Serious Fraud Office, the US Commodity Futures Trading Commission, the US Securities and Exchange Commission, the US Department of Justice and a number of State Attorneys General, as well as the European and Swiss Competition Commissions, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates including the BBA London Interbank Offered Rates (LIBOR) and the European Banking Federation’s Euribor, along with other reference rates. Certain Group companies were (at the relevant times) and remain members of various panels whose members make submissions to these bodies including the BBA LIBOR panels. No Group company is or was a member of the Euribor panel. Certain Group companies have received subpoenas and requests for information from certain government agencies and the Group is co-operating with their investigations.

Certain Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar LIBOR. The claims have been asserted by plaintiffs claiming to have had an interest in various types of financial instruments linked to US Dollar LIBOR. The allegations in these cases, the majority of which have been coordinated for pre-trial purposes in multi-district litigation proceedings (MDL) in the US District Court for the Southern District of New York (the ‘District Court’), are substantially similar to each other. The lawsuits allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act (RICO) and the Commodity Exchange Act (CEA), as well as various state statutes and common law doctrines. Certain of the plaintiffs’ claims have been dismissed by the District Court, various motions directed to the sufficiency of their pleading of certain claims are still pending, and many of these cases have been stayed by order of the District Court.

The Group is also reviewing its activities in relation to the setting of certain foreign exchange daily benchmark rates, following the FCA’s publicised initiation of an investigation into other financial institutions in relation to this activity. In addition, the Group, together with a number of other banks, has been named as a defendant in several actions in the District Court, in which the plaintiffs allege that the defendants manipulated WM/Reuters foreign exchange rates in violation of US antitrust laws. The time-frame for the Group and the other defendants to move to dismiss these claims has not yet been set.

It is currently not possible to predict the scope and ultimate outcome on the Group of the various regulatory investigations, private lawsuits or any related challenges to the interpretation or validity of any of the Group's contractual arrangements, including their timing and scale.

**FINANCIAL SERVICES COMPENSATION SCHEME**

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. Although the substantial majority of this loan, which totalled approximately £17 billion at 31 March 2013, will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants of the FSCS. In July 2013, the FSCS confirmed that it expects to raise compensation costs levies of approximately £1.1 billion on all deposit-taking participants over a three year measurement period from 2012 to 2014 to enable it to repay the balance of the HM Treasury loan which matures in 2016. The Group has provided for its share of the 2012 and 2013 element of the levy. The amount of future compensation costs levies payable by the Group depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants.

**INVESTIGATION INTO BANK OF SCOTLAND AND REPORT ON HBOS**

The FSA's enforcement investigation into Bank of Scotland plc's Corporate division between 2006 and 2008 concluded with the publication of a Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. On 12 September 2012 the FSA confirmed it was starting work on a public interest report on HBOS. That report is currently expected to be published in 2014.

**US SHAREHOLDER LITIGATION**

In November 2011 the Group and two former members of the Group's Board of Directors were named as defendants in a purported securities class action filed in the United States District Court for the Southern District of New York. The complaint asserted claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS. In October 2012 the court dismissed the complaint. The plaintiffs' appeal against this decision was dismissed on 19 September 2013 and the time limit for further appeals expired in December 2013.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 52: CONTINGENT LIABILITIES AND COMMITMENTS** continued

**US-SWISS TAX PROGRAMME**

The US Department of Justice (the DOJ) and the Swiss Federal Department of Finance announced on 29 August 2013 a programme (the Programme) for Swiss banks to obtain resolution concerning their status in connection with on-going investigations by the DOJ into individuals and entities that use foreign (i.e. non-U.S.) bank accounts to evade U.S. taxes and reporting requirements, and individuals and entities that facilitate or have facilitated the evasion of such taxes and reporting requirements. Swiss banks that choose to participate have to notify the DOJ of their election to categorise their relevant banking operations according to one of a number of defined categories under the Programme. The Group, which carried out private banking operations in Switzerland prior to disposing of these operations in November 2013, has notified the DOJ of its elected categorisation on the basis that while it believes it has operated in full compliance with all US federal tax laws, there remains the possibility that certain of its clients may not have declared their assets in compliance with such laws. The Group will continue to co-operate with the DOJ under the terms of the Programme. However, at this time, it is not possible to predict the ultimate outcome of the Group's participation in the Programme, including the timing and scale of any fine finally payable to the DOJ.

**TAX AUTHORITIES**

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where Her Majesty's Revenue and Customs ('HMRC') adopt a different interpretation and application of tax law which might lead to additional tax. The Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed the Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Group's deferred tax asset of approximately £400 million. The Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

**OTHER LEGAL ACTIONS AND REGULATORY MATTERS**

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

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| Contingent liabilities | | |
| Acceptances and endorsements | 204 | 107 |
| Other: | | |
| Other items serving as direct credit substitutes | 710 | 523 |
| Performance bonds and other transaction-related contingencies | 1,966 | 2,266 |
| | 2,676 | 2,789 |
| Total contingent liabilities | 2,880 | 2,896 |

The contingent liabilities of the Group arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| Commitments | | |
| Documentary credits and other short-term trade-related transactions | 54 | 11 |
| Forward asset purchases and forward deposits placed | 440 | 546 |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | |
| Less than 1 year original maturity: | | |
| Mortgage offers made | 9,559 | 7,404 |
| Other commitments | 55,002 | 53,196 |
| | 64,561 | 60,600 |
| 1 year or over original maturity | 40,616 | 40,794 |
| Total commitments | 105,671 | 101,951 |

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £56,292 million (2012: £52,733 million) was irrevocable.

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**NOTE 52: CONTINGENT LIABILITIES AND COMMITMENTS** continued

**OPERATING LEASE COMMITMENTS**

Where a Group company is the lessee the future minimum lease payments under non-cancellable premises operating leases are as follows:

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Not later than 1 year | 292 | 310 |
| Later than 1 year and not later than 5 years | 928 | 987 |
| Later than 5 years | 1,166 | 1,332 |
| Total operating lease commitments | 2,386 | 2,629 |

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

**CAPITAL COMMITMENTS**

Excluding commitments in respect of investment property (note 26), capital expenditure contracted but not provided for at 31 December 2013 amounted to £345 million (2012: £279 million). Of this amount, £344 million (2012: £276 million) related to assets to be leased to customers under operating leases. The Group’s management is confident that future net revenues and funding will be sufficient to cover these commitments.

## NOTE 53: FINANCIAL INSTRUMENTS

### (1) MEASUREMENT BASIS OF FINANCIAL ASSETS AND LIABILITIES

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

| | **Derivatives** | **At fair value through profit or loss** | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | **Designated as hedging instruments £m** | **Held for trading £m** | **Designated upon initial recognition £m** | **Available-for-sale £m** | **Loans and receivables £m** | **Held at amortised cost £m** | **Insurance contracts £m** | **Total £m** |
| **At 31 December 2013** | | | | | | | | |
| **Financial assets** | | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 49,915 | – | 49,915 |
| Items in the course of collection from banks | – | – | – | – | – | 1,007 | – | 1,007 |
| Trading and other financial assets at fair value through profit or loss | – | 37,350 | 105,333 | – | – | – | – | 142,683 |
| Derivative financial instruments | 6,787 | 26,338 | – | – | – | – | – | 33,125 |
| Loans and receivables: | | | | | | | | |
| Loans and advances to banks | – | – | – | – | 25,365 | – | – | 25,365 |
| Loans and advances to customers | – | – | – | – | 495,281 | – | – | 495,281 |
| Debt securities | – | – | – | – | 1,355 | – | – | 1,355 |
| | – | – | – | – | 522,001 | – | – | 522,001 |
| Available-for-sale financial assets | – | – | – | 43,976 | – | – | – | 43,976 |
| Total financial assets | 6,787 | 63,688 | 105,333 | 43,976 | 522,001 | 50,922 | – | 792,707 |
| Financial liabilities | | | | | | | | |
| Deposits from banks | – | – | – | – | – | 13,982 | – | 13,982 |
| Customer deposits | – | – | – | – | – | 441,311 | – | 441,311 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Items in course of transmission to banks | – | – | – | – | – | 774 | – | 774 |
| Trading and other financial liabilities at fair value through profit or loss | – | 38,319 | 5,306 | – | – | – | – | 43,625 |
| Derivative financial instruments | 4,518 | 25,946 | – | – | – | – | – | 30,464 |
| Notes in circulation | – | – | – | – | – | 1,176 | – | 1,176 |
| Debt securities in issue | – | – | – | – | – | 87,102 | – | 87,102 |
| Liabilities arising from insurance contracts and participating investment contracts | – | – | – | – | – | – | 82,777 | 82,777 |
| Liabilities arising from non-participating investment contracts | – | – | – | – | – | – | 27,590 | 27,590 |
| Unallocated surplus within insurance businesses | – | – | – | – | – | – | 391 | 391 |
| Financial guarantees | – | – | 50 | – | – | – | – | 50 |
| Subordinated liabilities | – | – | – | – | – | 32,312 | – | 32,312 |
| **Total financial liabilities** | 4,518 | 64,265 | 5,356 | – | – | 576,657 | 110,758 | 761,554 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 53: FINANCIAL INSTRUMENTS** continued

| | Derivatives designated as hedging instruments £m | At fair value through profit or loss Held for trading £m | Designated upon initial recognition £m | Available-for-sale £m | Loans and receivables £m | Held at amortised cost £m | Insurance contracts £m | Total £m |
|---|---|---|---|---|---|---|---|---|
| **At 31 December 2012[1]** | | | | | | | | |
| **Financial assets** | | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 80,298 | – | 80,298 |
| Items in the course of collection from banks | – | – | – | – | – | 1,256 | – | 1,256 |
| Trading and other financial assets at fair value through profit or loss | – | 23,345 | 137,275 | – | – | – | – | 160,620 |
| Derivative financial instruments | 11,571 | 44,986 | – | – | – | – | – | 56,557 |
| Loans and receivables: | | | | | | | | |
| Loans and advances to banks | – | – | – | – | 32,757 | – | – | 32,757 |
| Loans and advances to customers | – | – | – | – | 517,225 | – | – | 517,225 |
| Debt securities | – | – | – | – | 5,273 | – | – | 5,273 |
| | – | – | – | – | 555,255 | – | – | 555,255 |
| Available-for-sale financial assets | – | – | – | 31,374 | – | – | – | 31,374 |
| Total financial assets | 11,571 | 68,331 | 137,275 | 31,374 | 555,255 | 81,554 | – | 885,360 |
| Financial liabilities | | | | | | | | |
| Deposits from banks | – | – | – | – | – | 38,405 | – | 38,405 |
| Customer deposits | – | – | – | – | – | 426,912 | – | 426,912 |
| Items in course of transmission to banks | – | – | – | – | – | 996 | – | 996 |
| Trading and other financial liabilities at fair value through profit or loss | – | 27,692 | 5,700 | – | – | – | – | 33,392 |
| Derivative financial instruments | 6,598 | 42,078 | – | – | – | – | – | 48,676 |
| Notes in circulation | – | – | – | – | – | 1,198 | – | 1,198 |
| Debt securities in issue | – | – | – | – | – | 117,253 | – | 117,253 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Liabilities arising from insurance contracts and participating investment contracts | – | – | – | – | – | – | 82,953 | 82,953 |
| Liabilities arising from non-participating investment contracts | – | – | – | – | – | – | 54,372 | 54,372 |
| Unallocated surplus within insurance businesses | – | – | – | – | – | – | 267 | 267 |
| Financial guarantees | – | – | 48 | – | – | – | – | 48 |
| Subordinated liabilities | – | – | – | – | – | 34,092 | – | 34,092 |
| Total financial liabilities | 6,598 | 69,770 | 5,748 | – | – | 618,856 | 137,592 | 838,564 |

[1] Restated – see note 1.

**(2) RECLASSIFICATION OF FINANCIAL ASSETS**

No financial assets have been reclassified in 2013.

During 2012 the Group has reviewed its holding of government securities classified as held-to-maturity and in view of the fact that it was no longer the Group's intention to hold these to maturity, securities with a carrying amount of £10,811 million and a fair value of £11,979 million were reclassified as available-for-sale financial assets in December 2012.

No financial assets were reclassified in 2011.

In 2010, government securities with a fair value of £3,601 million were reclassified from available-for-sale financial assets to held-to-maturity investments reflecting the Group's then positive intent and ability to hold them until maturity.

In 2009, no financial assets were reclassified.

In 2008, in accordance with the amendment to IAS 39 that became applicable during that year, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, with effect from 1 July 2008, the Group transferred £2,993 million of assets previously classified as held for trading into loans and receivables. With effect from 1 November 2008, the Group transferred £437 million of assets previously classified as available-for-sale financial assets into loans and receivables. At the time of these transfers, the Group had the intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 6.3 per cent with the estimated recoverable cash flows of £3,524 million.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 53: FINANCIAL INSTRUMENTS** continued

**CARRYING VALUE AND FAIR VALUE OF RECLASSIFIED ASSETS**

The table below sets out the carrying value and fair value of reclassified financial assets.

| | 2013 Carrying value £m | Fair value £m | 2012 Carrying value £m | Fair value £m | 2011 Carrying value £m | Fair value £m | 2010 Carrying value £m | Fair value £m | 2009 Carrying value £m | Fair value £m | 2008 Carrying value £m | Fai val £m |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| From held for trading to loans and receivables | – | – | 11 | 9 | 67 | 56 | 750 | 727 | 1,833 | 1,822 | 2,883 | 2,9 |
| From available-for-sale financial assets to loans and receivables | – | – | 162 | 203 | 217 | 219 | 313 | 340 | 394 | 422 | 454 | 402 |
| From available-for-sale financial assets to held-to-maturity investments | – | – | – | – | 3,624 | 3,846 | 3,455 | 3,539 | – | – | – | – |
| From held-to-maturity investments to available-for-sale financial assets | 1,117 | 1,117 | 4,998 | 4,998 | – | – | – | – | – | – | – | – |
| Total carrying value and fair value | 1,117 | 1,117 | 5,171 | 5,210 | 3,908 | 4,121 | 4,518 | 4,606 | 2,227 | 2,244 | 3,337 | 3,3 |

During the year ended 31 December 2013, the carrying value of assets reclassified to loans and receivables decreased by £173 million due to sales and maturities of £173 million.

No financial assets have been reclassified in accordance with paragraphs 50B, 50D or 50E of IAS 39 since 2008; the following disclosures relate to those assets which were so reclassified in 2008.

A) ADDITIONAL FAIR VALUE GAINS (LOSSES) THAT WOULD HAVE BEEN RECOGNISED HAD THE RECLASSIFICATIONS NOT OCCURRED

The table below shows the additional gains (losses) that would have been recognised in the Group's income statement if the reclassifications had not occurred.

| | **2013** | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|---|
| | **£m** | £m | £m | £m | £m | £m |
| From held for trading to loans and receivables | 1 | 1 | (3) | (34) | 208 | (347) |

The table below shows the additional gains (losses) that would have been recognised in other comprehensive income if the reclassifications had not occurred.

| | **2013** | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|---|
| | **£m** | £m | £m | £m | £m | £m |
| From available-for-sale financial assets to loans and receivables | (56) | 24 | (68) | 69 | 161 | (108) |

B) ACTUAL AMOUNTS RECOGNISED IN RESPECT OF RECLASSIFIED ASSETS

After reclassification the reclassified financial assets contributed the following amounts to the Group income statement.

| | **2013** | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|---|
| | **£m** | £m | £m | £m | £m | £m |
| From held for trading to loans and receivables: | | | | | | |
| Net interest income | – | – | 1 | 24 | 55 | 31 |
| Impairment losses | – | – | – | (6) | (49) | (158) |
| **Total amounts recognised** | – | – | 1 | 18 | 6 | (127) |
| | 2013 | 2012 | 2011 | 2010 | 2009 | 2008 |
| | **£m** | £m | £m | £m | £m | £m |
| From available-for-sale financial assets to loans and receivables: | | | | | | |
| Net interest income | 1 | 1 | 2 | 1 | 34 | 3 |
| Impairment credit (losses) | – | 5 | (8) | (2) | (56) | (23) |
| Gains (losses) on disposal | (5) | – | – | – | – | – |
| **Total amounts recognised** | (4) | 6 | (6) | (1) | (22) | (20) |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 53: FINANCIAL INSTRUMENT** continued

**(3) FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES**

The following table summarises the carrying values of financial assets and liabilities presented on the Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

| | **2013** | | 2012[1] | |
|---|---|---|---|---|
| | Carrying value £m | Fair value £m | Carrying value £m | Fair value £m |
| Financial assets | | | | |
| Trading and other financial assets at fair value through profit or loss | **142,683** | **142,683** | 160,620 | 160,620 |
| Derivative financial instruments | **33,125** | **33,125** | 56,557 | 56,557 |
| Loans and receivables: | | | | |
| Loans and advances to banks | **25,365** | **25,296** | 32,757 | 32,746 |
| Loans and advances to customers: unimpaired | **473,239** | **464,453** | 484,868 | 474,061 |
| Loans and advances to customers: impaired | **22,042** | **22,042** | 32,357 | 32,357 |
| Debt securities | **1,355** | **1,251** | 5,273 | 5,402 |
| Available-for-sale financial assets | **43,976** | **43,976** | 31,374 | 31,374 |
| Financial liabilities | | | | |
| Deposits from banks | **13,982** | **14,101** | 38,405 | 38,738 |
| Customer deposits | **441,311** | **441,855** | 426,912 | 428,749 |
| Trading and other financial liabilities at fair value through profit or loss | **43,625** | **43,625** | 33,392 | 33,392 |
| Derivative financial instruments | **30,464** | **30,464** | 48,676 | 48,676 |
| Debt securities in issue | **87,102** | **90,803** | 117,253 | 122,847 |
| Liabilities arising from non-participating investment contracts | **27,590** | **27,590** | 54,372 | 54,372 |
| Financial guarantees | **50** | **50** | 48 | 48 |
| Subordinated liabilities | **32,312** | **34,449** | 34,092 | 36,382 |

[1] Restated – see note 1.

The carrying amount of the following financial instruments is a reasonable approximation of fair value; cash and balances at central banks, items in the course of collection from banks, items in course of transmission to banks and notes in circulation.

**(4) FAIR VALUE MEASUREMENT**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group’s financial position.

Fair value information is not provided for items that are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group’s consolidated balance sheet. These items include intangible assets, such as the value of the Group’s branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders’ equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

**NOTE 53: FINANCIAL INSTRUMENTS** continued

**VALUATION CONTROL FRAMEWORK**

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

**VALUATION OF FINANCIAL ASSETS AND LIABILITIES**

Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

LEVEL 1

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise equity shares, treasury bills and other government securities.

LEVEL 2

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

LEVEL 3

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Unless otherwise noted, the following disclosures are provided separately for assets and liabilities carried at fair value and those carried at amortised cost.

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 53: FINANCIAL INSTRUMENTS** continued

**FINANCIAL ASSETS AND LIABILITIES CARRIED AT FAIR VALUE**

VALUATION HIERARCHY

The table below analyses the financial assets and liabilities of the Group which are carried at fair value. They are categorised into levels 1 to 3 based on the degree to which their fair value is observable. The fair value measurement approach is recurring in nature.

Valuation hierarchy

| | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| At 31 December 2013 | | | | |
| Trading and other financial assets at fair value through profit or loss | | | | |
| Loans and advances to customers | – | 21,110 | – | 21,110 |
| Loans and advances to banks | – | 8,333 | – | 8,333 |
| Debt securities: | | | | |
| Government securities | 20,191 | 498 | – | 20,689 |
| Other public sector securities | – | 1,312 | 885 | 2,197 |
| Bank and building society certificates of deposit | – | 1,491 | – | 1,491 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | 30 | 768 | – | 798 |
| Other asset-backed securities | 171 | 756 | – | 927 |
| Corporate and other debt securities | 244 | 18,689 | 1,687 | 20,620 |
| | 20,636 | 23,514 | 2,572 | 46,722 |
| Equity shares | 64,690 | 53 | 1,660 | 66,403 |
| Treasury and other bills | 7 | 108 | – | 115 |
| Total trading and other financial assets at fair value through profit or loss | 85,333 | 53,118 | 4,232 | 142,683 |
| Available-for-sale financial assets | | | | |
| Debt securities: | | | | |
| Government securities | 38,262 | 28 | – | 38,290 |
| Bank and building society certificates of deposit | – | 208 | – | 208 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 1,263 | – | 1,263 |

| | | | | |
|---|---|---|---|---|
| Other asset-backed securities | – | 841 | 74 | 915 |
| Corporate and other debt securities | 56 | 1,799 | – | 1,855 |
| | 38,318 | 4,139 | 74 | 42,531 |
| Equity shares | 48 | 147 | 375 | 570 |
| Treasury and other bills | 852 | 23 | – | 875 |
| Total available-for-sale financial assets | 39,218 | 4,309 | 449 | 43,976 |
| Derivative financial instruments | 235 | 29,871 | 3,019 | 33,125 |
| Total financial assets carried at fair value | 124,786 | 87,298 | 7,700 | 219,784 |
| Trading and other financial liabilities at fair value through profit or loss | | | | |
| Liabilities held at fair value through profit or loss | – | 5,267 | 39 | 5,306 |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | – | 28,902 | – | 28,902 |
| Short positions in securities | 6,473 | 417 | – | 6,890 |
| Other | – | 2,527 | – | 2,527 |
| | 6,473 | 31,846 | – | 38,319 |
| Total trading and other financial liabilities at fair value through profit or loss | 6,473 | 37,113 | 39 | 43,625 |
| Derivative financial instruments | 119 | 29,359 | 986 | 30,464 |
| Financial guarantees | – | – | 50 | 50 |
| Total financial liabilities carried at fair value | 6,592 | 66,472 | 1,075 | 74,139 |

There were no significant transfers between level 1 and level 2 during the year.

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**Note 53: Financial instruments** continued

| | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| At 31 December 2012 | | | | |
| Trading and other financial assets at fair value through profit or loss | | | | |
| Loans and advances to customers | – | 13,632 | – | 13,632 |
| Loans and advances to banks | – | 919 | – | 919 |
| Debt securities: | | | | |
| Government securities | 19,138 | 2,207 | – | 21,345 |
| Other public sector securities | – | 1,056 | – | 1,056 |
| Bank and building society certificates of deposit | 68 | 3,326 | – | 3,394 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | 232 | 693 | – | 925 |
| Other asset-backed securities | 348 | 1,565 | – | 1,913 |
| Corporate and other debt securities | 8,346 | 17,694 | 1,519 | 27,559 |
| | 28,132 | 26,541 | 1,519 | 56,192 |
| Equity shares | 87,566 | 94 | 1,787 | 89,447 |
| Treasury and other bills | 430 | – | – | 430 |
| Total trading and other financial assets at fair value through profit or loss | 116,128 | 41,186 | 3,306 | 160,620 |
| Available-for-sale financial assets | | | | |
| Debt securities: | | | | |
| Government securities | 25,555 | – | – | 25,555 |
| Bank and building society certificates of deposit | 42 | 146 | – | 188 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 1,524 | – | 1,524 |
| Other asset-backed securities | – | 687 | 73 | 760 |
| Corporate and other debt securities | 22 | 1,826 | – | 1,848 |
| | 25,619 | 4,183 | 73 | 29,875 |
| Equity shares | 21 | 99 | 408 | 528 |
| Treasury and other bills | 869 | 16 | 86 | 971 |
| Total available-for-sale financial assets | 26,509 | 4,298 | 567 | 31,374 |
| Derivative financial instruments | 76 | 54,123 | 2,358 | 56,557 |
| Total financial assets carried at fair value | 142,713 | 99,607 | 6,231 | 248,551 |
| Trading and other financial liabilities at fair value through profit or loss | | | | |
| Liabilities held at fair value through profit or loss | – | 5,700 | – | 5,700 |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | – | 24,553 | – | 24,553 |
| Short positions in securities | 1,850 | 350 | – | 2,200 |
| Other | 15 | 924 | – | 939 |
| | 1,865 | 25,827 | – | 27,692 |
| Total trading and other financial liabilities at fair value through profit or loss | 1,865 | 31,527 | – | 33,392 |
| Derivative financial instruments | 36 | 48,097 | 543 | 48,676 |
| Financial guarantees | – | – | 48 | 48 |

| | | | | |
|---|---|---|---|---|
| Total financial liabilities carried at fair value | 1,901 | 79,624 | 591 | 82,116 |

There were no significant transfers between level 1 and level 2 during the year.

notes to the consolidated financial statements

**Note 53: Financial instruments** continued

Valuation methodology

*Loans and advances and debt securities*

Loans and advances and debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

*Equity investments*

Unlisted equity and fund investments are valued using different techniques in accordance with the Group's valuation policy and International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

– A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.

– Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.

–

For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

Unlisted equity investments and investments in property partnerships held in the life assurance funds are valued using third party valuations. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

*Derivatives*

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

– Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.

– Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.

– Credit derivatives which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.

– Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

The Group's level 3 derivative assets include £1,212 million (2012: £1,421 million) in respect of the value of the embedded equity conversion feature of the Enhanced Capital Notes issued in December 2009. The embedded equity conversion feature is valued by comparing the market price of the Enhanced Capital Notes with the market price of similar bonds without the conversion feature. The latter is calculated by discounting the expected Enhanced Capital Note cash flows in the absence of a conversion using prevailing market yields for similar capital securities without the conversion feature. The market price of the Enhanced Capital Notes was calculated with reference to multiple broker quotes.

*Liabilities held at fair value through profit or loss*

These principally comprise debt securities in issue which are classified as level 2 and their fair value is determined using techniques whose inputs are based on observable market data.

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notes to the consolidated financial statements

**Note 53: Financial instruments** continued

MoVements in LeVel 3 portfolio

The table below analyses movements in level 3 financial assets carried at fair value (recurring measurement).

| | Trading and other financial assets at fair value through profit or loss £m | **Available-for-sale £m** | **Derivative assets £m** | Total level 3 assets carried at fair value (recurring basis) £m |
|---|---|---|---|---|
| At 1 January 2012 | 2,941 | 2,056 | 2,649 | 7,646 |
| Exchange and other adjustments | 10 | (60) | 12 | (38) |
| Gains recognised in the income statement within other income | 166 | (356) | (335) | (525) |
| Losses recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | – | (58) | – | (58) |
| Purchases | 513 | 218 | 45 | 776 |
| Sales | (570) | (1,358) | (13) | (1,941) |
| Transfers into the level 3 portfolio | 337 | 138 | – | 475 |
| Transfers out of the level 3 portfolio | (91) | (13) | – | (104) |
| At 31 December 2012 | 3,306 | 567 | 2,358 | 6,231 |
| Exchange and other adjustments | 21 | 15 | 2 | 38 |
| Gains recognised in the income statement within other income | 296 | – | 144 | 440 |
| Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | – | 40 | – | 40 |
| Purchases | 582 | 43 | 271 | 896 |
| Sales | (631) | (224) | (102) | (957) |
| Transfers into the level 3 portfolio | 995 | 12 | 354 | 1,361 |
| Transfers out of the level 3 portfolio | (337) | (4) | (8) | (349) |
| **At 31 December 2013** | 4,232 | 449 | 3,019 | 7,700 |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2013 | 70 | 5 | 159 | 234 |
| Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 | 85 | (33) | (335) | (283) |

December 2012

The table below analyses movements in the Level 3 financial liabilities portfolio.

| | Trading and other financial liabilities at fair value through profit or loss | **Derivative liabilities** | **Financial guarantees** | **Total level 3 financial liabilities carried at fair value** |
|---|---|---|---|---|
| | **£m** | **£m** | **£m** | **£m** |
| At 1 January 2012 | – | 741 | 49 | 790 |
| Exchange and other adjustments | – | 10 | – | 10 |
| Gains recognised in the income statement within other income | – | (227) | (3) | (230) |
| Additions | – | 28 | 2 | 30 |
| Redemptions | – | (25) | – | (25) |
| Transfers into the level 3 portfolio | – | 16 | – | 16 |
| At 31 December 2012 | – | 543 | 48 | 591 |
| Exchange and other adjustments | **–** | **8** | **–** | **8** |
| Losses (gains) recognised in the income statement within other income | 10 | (30) | 3 | (17) |
| Additions | 29 | 262 | – | 291 |
| Redemptions | – | (29) | (1) | (30) |
| Transfers into the level 3 portfolio | – | 233 | – | 233 |
| Transfers out of the level 3 portfolio | – | (1) | – | (1) |
| At 31 December 2013 | 39 | 986 | 50 | 1,075 |
| Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2013 | (10) | 20 | (3) | 7 |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2012 | – | 223 | 3 | 226 |

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notes to the consolidated financial statements

**Note 53: Financial instruments** continued

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

SensitiVity of leVel 3 Valuations

| | | | At 31 December 2013 | | | At 31 December 2012[5] | | |
|---|---|---|---|---|---|---|---|---|
| | | | | **Effect of reasonably possible alternative assumptions[2]** | | | Effect of reasonably possible alternative assumptions [2] | |
| | **Valuation techniques** | **Significant unobservable inputs[1]** | Carrying value £m | Favourable changes £m | Unfavourable changes £m | Carrying value £m | Favourable changes £m | Unfavourable changes £m |
| Trading and other financial assets at fair value through profit or loss | | | | | | | | |
| Debt securities | Discounted cash flows | Credit spreads (bps) n/a[3] | 18 | 5 | (2) | – | – | – |
| Equity and venture capital investments | Market approach | Earnings multiple (0.2/14.6) | 2,132 | 70 | (70) | 1,854 | 51 | (51) |
| | Underlying asset/ net asset value (incl. property prices)[4] | n/a | 130 | – | – | 227 | – | – |
| Unlisted equities and property partnerships in the life funds | Underlying asset/ net asset value (incl. property prices)[4] | n/a | 1,952 | – | – | 1,225 | – | – |
| | | | 4,232 | | | 3,306 | | |
| Available-for-sale financial assets | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Asset-backed securities | Lead manager or broker quote/ consensus pricing | n/a | 74 | – | – | 73 | – | – |
| Equity and venture capital investments | Underlying asset/ net asset value (incl. property prices)[4] | n/a | 375 | 28 | (19 ) | 494 | 36 | (11 ) |
| | | | 449 | | | 567 | | |
| Derivative financial assets | | | | | | | | |
| Embedded equity conversion feature | Lead manager or broker quote | Equity conversion feature spread (199 bps/420 bps) | 1,212 | 59 | (58 ) | 1,421 | 63 | – |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (62 bps/192 bps) | 1,461 | 66 | (39 ) | 899 | 69 | (48 ) |
| | Option pricing model | Interest rate volatility (3%/112%) | 346 | 6 | (7 ) | 38 | 2 | (21 ) |
| | | | 3,019 | | | 2,358 | | |
| Level 3 financial assets carried at fair value | | | 7,700 | | | 6,231 | | |
| Trading and other financial liabilities at fair value through profit or loss | | | 39 | 1 | (1 ) | – | – | – |
| Derivative financial liabilities | | | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (62 bps/192 bps) | 754 | – | – | 475 | – | – |
| | Option pricing model | Interest rate volatility (3%/112%) | 232 | – | – | 68 | – | – |
| | | | 986 | | | 543 | | |
| Financial guarantees | | | 50 | | | 48 | | |
| Level 3 financial liabilities carried at fair value | | | 1,075 | | | 591 | | |

1 Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

2 Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

[3] A single pricing source is used.

[4] Underlying asset/net asset values represent fair value.

[5] Comparatives are provided only where disclosures were required in 2012.

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notes to the consolidated financial statements

**Note 53: Financial instruments** continued

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are as follows:

– Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.

– Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.

– Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.

– Earnings multiples are used to value certain unlisted equity investments; a higher earnings multiple will result in a higher fair value.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

*Debt securities*

Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

*Derivatives*

Reasonably possible alternative assumptions have been determined in respect of the Group's derivative portfolios as follows:

- In respect of the embedded equity conversion feature of the Enhanced Capital Notes, the sensitivity was based on the absolute difference between the actual price of the enhanced capital note and the closest, alternative broker quote available plus the impact of applying a 10 bps increase/decrease in the market yield used to derive a market price for similar bonds without the conversion feature. The effect of interdependency of the assumptions is not material to the effect of applying reasonably possible alternative assumptions to the valuations of derivative financial instruments.

- Uncollateralised inflation swaps are valued using appropriate discount spreads for such transactions. These spreads are not generally observable for longer maturities. The reasonably possible alternative valuations reflect flexing of the spreads for the differing maturities to alternative values of between 62 bps and 192 bps (2012: 51 bps and 260 bps).

- Swaptions are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range of 3 per cent to 112 per cent (2012: 31 per cent and 79 per cent).

*Unlisted equity, venture capital investments and investments in property partnerships*

The valuation techniques used for unlisted equity and venture capital investments vary depending on the nature of the investment. Reasonably possible alternative valuations for these investments have been calculated by reference to the approach taken, as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

- for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;

- the discount rates used in discounted cash flow valuations; and
- in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

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notes to the consolidated financial statements

**Note 53: Financial instruments** continued

**Financial assets and liabilities carried at amortised cost**

Valuation hierarchy

The table below analyses the fair values of the financial assets and liabilities of the Group which are carried at amortised cost. They are categorised into levels 1 to 3 based on the degree to which their fair value is observable.

| At 31 December 2013 | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| Financial assets | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers | – | – | 486,495 | 486,495 |
| Loans and advances to banks | – | – | 25,296 | 25,296 |
| Debt securities | 157 | 42 | 1,052 | 1,251 |
| Financial liabilities | | | | |
| Deposits from banks | – | 13,957 | 144 | 14,101 |
| Customer deposits | – | 423,122 | 18,733 | 441,855 |
| Debt securities in issue | – | 90,628 | 175 | 90,803 |
| Subordinated liabilities | – | 34,449 | – | 34,449 |

Note: Comparatives not provided as disclosure not required in 2012.

Valuation methodology

*Financial assets*

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value taking into account expected credit losses, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair value of wholesale loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk.

The fair values of debt securities, which were previously within assets held for trading and were reclassified to loans and receivables, are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

*Financial liabilities*

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using discounted cash flow techniques at a rate whcih reflects market rates of interest and the Group’s own credit spread.

notes to the consolidated financial statements

**Note 53: Financial instruments** continued

**Derivative valuation adjustments**

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

*(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties*
The following table summarises the movement on this valuation adjustment account during 2013 and 2012:

| | 2013 £m | 2012 £m |
|---|---|---|
| At 1 January | 897 | 1,226 |
| Income statement credit | (241) | (209) |
| Transfers | (158) | (120) |
| At 31 December | 498 | 897 |

Represented by:

| | 2013 £m | 2012 £m |
|---|---|---|
| Credit Valuation Adjustment | 485 | 928 |
| Debit Valuation Adjustment | (122) | (174) |
| Funding Valuation Adjustment | 135 | 143 |
| | 498 | 897 |

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group’s own credit spread respectively.

The CVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised asset;

– expectations of future market volatility of the underlying asset; and

– expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £67 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. For these, the CVA is calculated on an add-on basis (in total contributing £5 million of the overall CVA balance at 31 December 2013).

The DVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised liability;

– expectations of future market volatility of the underlying liability; and

– the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £89 million to £211 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £187 million fall in the overall valuation adjustment to £177 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding certain uncollateralised derivative positions where the Group considers that this cost is included in market pricing. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £9 million.

notes to the consolidated financial statements

**Note 53: Financial instruments** continued

*(ii) Uncollateralised derivative valuation adjustments – monoline counterparties*

The Group has no significant derivative exposures remaining against monoline counterparties.

*(iii) Market liquidity*

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2013, the Group's derivative trading business held mid to bid-offer valuation adjustments of £70 million (2012: £103 million).

*(iv) LIBOR/Overnight Index Swap basis*

The Group's derivative trading business applies £50 million (31 December 2012: £74 million) of valuation adjustments against the changing market approach to valuing derivatives that are subject to daily collateral margin, where standard market practice is to pay interest on an Overnight Index Swap basis rather than a LIBOR rate.

No credit valuation adjustment is taken on collateralised swaps.

OWN CREDIT ADJUSTMENTS

The carrying amount of issued notes that are designated at fair value through profit or loss is adjusted to reflect the effect of changes in own credit spreads. The resulting gain or loss is recognised in the income statement.

At 31 December 2013, the own credit adjustment arising from the fair valuation of £5,267 million (2012: £5,700 million) of the Group's debt securities in issue designated at fair value through profit or loss resulted in a gain of £40 million (2012: loss of £437 million).

**(5) Transfers of financial assets**

**A. Transferred financial assets that continue to be recognised in full**

The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets covered as substantially all of the risks and rewards, including credit, interest rate, prepayment and other price risks are retained by the Group. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 21, included within loans and receivables are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all of a majority of the risks and rewards associated with these loans, including credit, interest rate, prepayment and liquidity risk, they remain on the Group's balance sheet. Assets transferred into the Group's securitisation and covered bond programmes are not available to be used by the Group whilst the assets are within the programmes. However, the Group retains the right to remove loans from the covered bond programmes where they are in excess of the programme's requirements. In addition, where the Group has retained some of the notes issued by securitisation and covered bond programmes, the Group has the ability to sell or pledge these retained notes.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 35). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

| At 31 December 2013 | Carrying value of transferred assets £m | Carrying value of associated liabilities £m |
|---|---|---|
| Repurchase and securities lending transactions | | |
| Trading and other financial assets at fair value through profit or loss | 10,832 | 927 |
| Available-for-sale financial assets | 6,093 | 3,726 |
| Loans and receivables: | | |
| Loans and advances to customers | 19,074 | 3,936 |
| Debt securities classified as loans and receivables | 88 | – |
| Securitisation programmes | | |
| Loans and receivables: | | |
| Loans and advances to customers | 80,878 | 18,613[1] |

[1] Excludes securitisation notes held by the Group (£38,288 million).
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notes to the consolidated financial statements

**Note 53: Financial instruments** continued

| At 31 December 2012 | Carrying value of transferred assets £m | Carrying value of associated liabilities £m |
|---|---|---|
| **Repurchase and securities lending transactions** | | |
| Trading and other financial assets at fair value through profit or loss | 10,612 | 620 |
| Available-for-sale financial assets | 8,967 | 4,693 |
| Loans and receivables: | | |
| Loans and advances to customers | 19,015 | 6,662 |
| Debt securities classified as loans and receivables | 498 | 346 |
| **Securitisation programmes** | | |
| Loans and receivables: | | |
| Loans and advances to customers[1] | 118,183 | 28,059 [2] |

[1] Includes US residential mortgage-backed securities and associated liabilities whose carrying values were £185 million and £221 million respectively; the associated liabilities have recourse only to the securities transferred and, at 31 December 2012, the fair values of the securities and the associated liabilities were £244 million and £311 million respectively, a difference of £67 million.

[2] Excludes securitisation notes held by the Group (£58,732 million).

**B. Transferred financial assets derecognised in their entirety with ongoing exposure**

The following information by type of ongoing exposure relates to assets and liabilities arising from contractual rights or obligations retained or obtained in connection with financial assets that have been derecognised in their entirety.

| | **Carrying amount of ongoing exposure in balance sheet** | | |
|---|---|---|---|
| At 31 December 2013 | At fair value through profit or loss | Fair value of | Maximum |

| | Loans and Receivables £m | Designated upon initial recognition £m | ongoing exposure £m | exposure to loss £m |
|---|---|---|---|---|
| Debt securities | 78 | – | 76 | 78[1] |

| At 31 December 2012 | Carrying amount of ongoing exposure in balance sheet: Loans and receivables £m | At fair value through profit or loss Designated upon initial recognition £m | Fair value of ongoing exposure £m | Maximum exposure to loss £m |
|---|---|---|---|---|
| Debt securities | 119 | – | 102 | 119[1] |
| Fund investments | – | 70 | 70 | 100[2] |
| Total | 119 | 70 | 172 | 219 |

1 Amount represents the carrying amount of the asset.

2 Amount represents the carrying amount of the asset plus undrawn commitments of £30 million.

Debt securities shown in the table above are notes held in non-controlled securitisation vehicles representing the Group’s ongoing involvement in financial assets transferred into those securitisation vehicles in prior years. The debt securities, which benefit from significant credit enhancement, are classified as available-for-sale financial assets and are managed on a similar basis to the Group’s other non-traded asset-backed securities.

Fund investments shown in the table above are equity and debt interests in an investment fund representing the Group’s ongoing involvement in financial assets transferred into the fund in a prior year. The fund investments were designated at fair value through profit or loss and are managed on a similar basis to the Group’s trading assets.

The Group has no obligation or option to repurchase any of the assets transferred.

notes to the consolidated financial statements

**Note 53: Financial instruments** continued

**Amounts recognised in the income statement**

In respect of debt securities shown above, an amount of £1 million was recognised during the year (2012: £2 million; £6 million cumulatively since derecognition) within net interest income.

In respect of fund investments shown above, an amount of £nil million was recognised during the year (2012: £3 million; £55 million cumulatively since derecognition) within net trading income.

**(6) Financial instruments subject to offsetting, enforceable master netting agreements and similar arrangements**

The following information relates to financial assets and liabilities which have been set off in the balance sheet and those which have not been set off but for which the Group has enforceable master netting agreements in place with counterparties.

| At 31 December 2013 | Gross amounts of assets/liabilities £m | Amounts set off in the balance sheet[3] £m | Net amounts presented in the balance sheet £m |
|---|---|---|---|
| Financial assets | | | |
| Trading and other financial assets at fair value through profit or loss[1] | 113,395 | – | 113,395 |
| Derivative financial instruments | 50,285 | (17,160) | 33,125 |
| Loans and receivables: | | | |
| Loans and advances to banks[1] | 25,182 | – | 25,182 |
| Loans and advances to customers[1] | 495,161 | – | 495,161 |
| Debt securities | 1,355 | – | 1,355 |
| Reverse repurchase agreements | 34,028 | (4,437) | 29,591 |
| Available-for-sale financial assets | 43,976 | – | 43,976 |
| Financial liabilities | | | |
| Deposits from banks[2] | 12,108 | – | 12,108 |

| | | | |
|---|---|---|---|
| Customer deposits[2] | 438,333 | – | 438,333 |
| Trading and after financial liabilities at fair value through profit or loss[2] | 14,723 | – | 14,723 |
| Repurchase agreements | 38,191 | (4,437 ) | 33,754 |
| Derivative financial instruments | 47,624 | (17,160 ) | 30,464 |

| At 31 December 2013 | Net amounts presented in the balance sheet £m | **Related amounts where set off in the balance sheet not permitted[4]** Financial instruments £m | Cash collateral received/ pledged £m | Potential net amounts if offset of related amounts permitted £m |
|---|---|---|---|---|
| Financial assets | | | | |
| Trading and other financial assets at fair value through profit or loss[1] | 113,395 | (903 ) | – | 112,492 |
| Derivative financial instruments | 33,125 | (19,479) | (3,188 ) | 10,458 |
| Loans and receivables: | | | | |
| Loans and advances to banks[1] | 25,182 | – | – | 25,182 |
| Loans and advances to customers[1] | 495,161 | (10,958) | (49 ) | 484,154 |
| Debt securities | 1,355 | – | – | 1,355 |
| Reverse repurchase agreements | 29,591 | (4,160 ) | (416 ) | 25,015 |
| Available-for-sale financial assets | 43,976 | (3,782 ) | – | 40,194 |
| Financial liabilities | | | | |
| Deposits from banks[2] | 12,108 | – | (2,798 ) | 9,310 |
| Customer deposits[2] | 438,333 | (6,811 ) | (806 ) | 430,716 |
| Trading and after financial liabilities at fair value through profit or loss[2] | 14,723 | – | – | 14,723 |
| Repurchase agreements | 33,754 | (12,992) | (49 ) | 20,713 |
| Derivative financial instruments | 30,464 | (19,479) | – | 10,985 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 53: FINANCIAL INSTRUMENTS** continued

| At 31 December 2012 | Gross amounts of assets/liabilities £m | Amounts set off in the balance sheet[3] £m | Net amounts presented in the balance sheet £m |
|---|---|---|---|
| **Financial assets** | | | |
| Trading and other financial assets at fair value through profit or loss[1] | 146,187 | – | 146,187 |
| Derivative financial instruments | 72,192 | (15,635 ) | 56,557 |
| Loans and receivables: | | | |
| Loans and advances to banks[1] | 32,095 | – | 32,095 |
| Loans and advances to customers[1] | 512,138 | – | 512,138 |
| Debt securities | 5,273 | – | 5,273 |
| Reverse repurchase agreements | 25,476 | (5,294 ) | 20,182 |
| Available-for-sale financial assets | 31,374 | – | 31,374 |
| **Financial liabilities** | | | |
| Deposits from banks[2] | 15,037 | – | 15,037 |
| Customer deposits[2] | 422,479 | – | 422,479 |
| Trading and after financial liabilities at fair value through profit or loss[2] | 8,839 | – | 8,839 |
| Repurchase agreements | 57,648 | (5,294 ) | 52,354 |
| Derivative financial instruments | 64,311 | (15,635 ) | 48,676 |

| At 31 December 2012 | Net amounts presented in the balance sheet £m | Related amounts where set off in the balance sheet not permitted[4] | | Potential net amounts if offset of related amounts permitted £m |
|---|---|---|---|---|
| | | Financial instruments £m | Cash collateral received/pledged £m | |
| **Financial assets** | | | | |
| Trading and other financial assets at fair value through profit or loss[1] | 146,187 | (612 ) | – | 145,575 |
| Derivative financial instruments | 56,557 | (38,158 ) | (5,429 ) | 12,970 |
| Loans and receivables: | | | | |
| Loans and advances to banks[1] | 32,095 | – | (135 ) | 31,960 |
| Loans and advances to customers[1] | 512,138 | (13,140 ) | (2 ) | 498,996 |

| | | | | |
|---|---|---|---|---|
| Debt securities | 5,273 | (344 ) | – | 4,929 |
| Reverse repurchase agreements | 20,182 | (8,863 ) | (196 ) | 11,123 |
| Available-or-sale financial assets | 31,374 | (4,716 ) | – | 26,658 |
| **Financial liabilities** | | | | |
| Deposits from banks² | 15,037 | – | (5,259 ) | 9,778 |
| Customer deposits² | 422,479 | (5,728 ) | (367 ) | 416,384 |
| Trading and after financial liabilities at fair value through profit or loss² | 8,839 | – | – | 8,839 |
| Repurchase agreements | 52,354 | (21,498) | (1 ) | 30,855 |
| Derivative financial instruments | 48,676 | (38,158) | (135 ) | 10,383 |

1 Excluding reverse repurchase agreements.

2 Excluding repurchase agreements.

3 The amounts set off in the balance sheet as shown above represent derivatives and repurchase agreements with central clearing houses which meet the criteria for offsetting under IAS 32.

4 The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over collateralisation have not been taken into account in the above table.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT**

As a bancassurer, financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; liquidity risk; capital risk; and insurance risk. Information about the Group's exposure to each of the above risks and capital can be found on pages 45 to 133. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

**MARKET RISK**

The Group uses various market risk measures for risk reporting and setting risk appetite limits and triggers. These measures include Value at Risk and Stress Scenarios.

**INTEREST RATE RISK**

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There is a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However, a significant proportion of the Group's lending assets, for example many personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt.

At 31 December 2013 the aggregate notional principal of interest rate swaps designated as fair value hedges was £154,657 million (2012: £135,516 million) with a net fair value asset of £3,663 million (2012: asset of £4,246 million) (note 18). The losses on the hedging instruments were £933 million (2012: gains of £572 million). The gains on the hedged items attributable to the hedged risk were £872 million (2012: losses of £560 million).

In addition the Group has cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. Note 18 shows when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2013 was £559,690 million (2012: £86,190 million) with a net fair value liability of £1,347 million (2012: asset of £215 million) (note 18). In 2013, ineffectiveness recognised in the income statement that arises from cash flow hedges was a loss of £60 million (2012: gain of £6 million).

**CURRENCY RISK**

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group’s overseas operations.

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. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the market and liquidity risk function in London. Associated VaR and the closing, average, maximum and minimum are disclosed on page 104.

Risk arises from the Group’s investments in its overseas operations. The Group’s structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using currency borrowings. At 31 December 2013 the aggregate principal of these currency borrowings was £1,695 million (2012: £2,489 million). In 2013, an ineffectiveness gain of £16 million before tax and £12 million after tax (2012: ineffectiveness loss of £1 million before and after tax) was recognised in the income statement arising from net investment hedges.

The Group’s main overseas operations are in the Americas, Asia, Australasia and Europe. Details of the Group’s structural foreign currency exposures, after net investment hedges, are as follows:

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

## FUNCTIONAL CURRENCY OF GROUP OPERATIONS

| | 2013 £m | 2012 £m |
|---|---|---|
| Euro: | | |
| Gross exposure | 567 | 919 |
| Net investment hedge | (464) | (842) |
| | 103 | 77 |
| US dollar: | | |
| Gross exposure | 379 | 316 |
| Net investment hedge | (341) | (542) |
| | 38 | (226) |
| Swiss franc: | | |
| Gross exposure | (7) | 6 |
| Net investment hedge | – | (9) |
| | (7) | (3) |
| Australian dollar: | | |
| Gross exposure | 853 | 1,104 |
| Net investment hedge | (866) | (1,077) |
| | (13) | 27 |
| Japanese yen: | | |
| Gross exposure | (1) | 19 |
| Net investment hedge | (1) | (19) |
| | (2) | – |
| Other non-sterling | 106 | 106 |
| Total structural foreign currency exposures, after net investment hedges | 225 | (19) |

## CREDIT RISK

The Group’s credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom, the European Union and the United States. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the 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 uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivative based transactions.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

**A. MAXIMUM CREDIT EXPOSURE**

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss, which includes amounts held to cover unit-linked and With Profits funds liabilities, is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

| | **2013** | 2012[1] |
|---|---|---|
| | **£m** | £m |
| Loans and receivables: | | |
| Loans and advances to banks, net[2] | **25,365** | 32,757 |
| Loans and advances to customers, net[2] | **495,281** | 517,225 |
| Debt securities, net[2] | **1,355** | 5,273 |
| Deposit amounts available for offset[3] | **(6,811 )** | (5,728 ) |
| | **515,190** | 549,527 |
| Available-for-sale financial assets (excluding equity shares) | **43,406** | 30,846 |
| Trading and other financial assets at fair value through profit or loss (excluding equity shares)[4]: | | |
| Loans and advances | **29,443** | 14,551 |
| Debt securities, treasury and other bills | **46,837** | 56,622 |
| | **76,280** | 71,173 |
| Derivative assets: | | |
| Derivative assets, before offsetting under master netting arrangements | **33,125** | 56,557 |
| Amounts available for offset under master netting arrangements[3] | **(19,479 )** | (38,158 ) |
| | **13,646** | 18,399 |
| Assets arising from reinsurance contracts held | **732** | 2,320 |
| Financial guarantees | **8,591** | 9,520 |
| Irrevocable loan commitments and other credit-related contingencies[5] | **59,172** | 55,629 |
| **Maximum credit risk exposure** | **717,017** | 737,414 |
| **Maximum credit risk exposure before offset items** | **743,307** | 781,300 |

1 Restated – see note 1.

2 Amounts shown net of related impairment allowances.

3 Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

4 Includes assets within the Group's unit-linked funds for which credit risk is borne by the policyholders and assets within the Group's With-Profits funds for which credit risk is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back related contract liabilities.

5 See note 52 – Contingent liabilities and commitments for further information.

**B. CREDIT QUALITY OF ASSETS**

LOANS AND RECEIVABLES

The disclosures in the table below and those on pages F-116 and F-117 are produced under the underlying basis used for the Group's segmental reporting. The Group believes that, for reporting periods following a significant acquisition such as the acquisition of HBOS in 2009, this underlying basis, which includes the allowance for loan losses at the acquisition date on a gross basis, more fairly reflects the underlying provisioning status of the loans. The remaining acquisition-related fair value adjustments in respect of this lending are therefore identified separately in this table.

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

LOANS AND ADVANCES

| | Loans and advances to banks £m | Loans and advances to customers Retail – mortgages £m | Retail – other £m | Wholesale £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | |
| Neither past due nor impaired | 25,219 | 318,668 | 36,789 | 110,093 | 465,550 | 29,443 |
| Past due but not impaired | 146 | 12,329 | 580 | 786 | 13,695 | – |
| Impaired – no provision required | – | 637 | 1,284 | 1,824 | 3,745 | – |
| – provision held | – | 6,229 | 1,456 | 20,829 | 28,514 | – |
| Gross | 25,365 | 337,863 | 40,109 | 133,532 | 511,504 | 29,443 |
| Allowance for impairment losses | – | (2,194) | (1,044) | (12,469) | (15,707) | – |
| Fair value adjustments | – | | | | (516) | – |
| Net balance sheet carrying value | 25,365 | | | | 495,281 | 29,443 |
| At 31 December 2012[1] | | | | | | |
| Neither past due nor impaired | 32,726 | 319,613 | 41,223 | 117,613 | 478,449 | 14,551 |
| Past due but not impaired | 31 | 12,880 | 922 | 1,527 | 15,329 | – |
| Impaired – no provision required | – | 741 | 1,530 | 1,504 | 3,775 | – |
| – provision held | 3 | 7,391 | 2,124 | 33,003 | 42,518 | – |
| Gross | 32,760 | 340,625 | 45,799 | 153,647 | 540,071 | 14,551 |
| Allowance for impairment losses | (3) | (2,845) | (1,326) | (17,601) | (21,772) | – |
| Fair value adjustments | – | | | | (1,074) | – |
| Net balance sheet carrying value | 32,757 | | | | 517,225 | 14,551 |

[1] Restated – see note 1.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(H). All impaired loans which exceed certain thresholds, principally within the Group's Commercial Banking division, are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances which are individually determined to be impaired with a gross amount before impairment allowances of £22,390 million (31 December 2012: £34,533 million).

The table below sets out the reconciliation of the allowance for impairment losses of £11,966 million (2012: £15,250 million) shown in note 24 to the allowance for impairment losses on an underlying basis of £15,707 million (2012: £21,772 million) shown above:

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| Allowance for impairment losses on loans and advances to customers | 11,966 | 15,250 |
| HBOS allowance at 16 January 2009[1] | 11,147 | 11,147 |
| HBOS charge covered by fair value adjustments[2] | 11,815 | 11,306 |
| Amounts subsequently written off | (19,674) | (16,383) |
| | 3,288 | 6,070 |
| Foreign exchange and other movements | 453 | 452 |
| Allowance for impairment losses on loans and advances to customers on an underlying basis | 15,707 | 21,772 |

[1] Comprises an allowance held at 31 December 2008 of £10,693 million and a charge for the period from 1 January 2009 to 16 January 2009 of £454 million.

[2] This represents the element of the charge on loans and advances to customers in HBOS's results that was included within the Group's fair value adjustments in respect of the acquisition of HBOS on 16 January 2009.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

LOANS AND ADVANCES WHICH ARE NEITHER PAST DUE NOR IMPAIRED

| | Loans and | **Loans and advances to customers** | | | | Loans and advances designated at fair value |
|---|---|---|---|---|---|---|
| | **advances to banks £m** | **Retail – mortgages £m** | **Retail – other £m** | **Wholesale £m** | **Total £m** | through profit or loss £m |
| At 31 December 2013 | | | | | | |
| Good quality | 25,044 | 314,749 | 29,129 | 68,674 | | 29,432 |
| Satisfactory quality | 171 | 2,948 | 6,414 | 29,038 | | 7 |
| Lower quality | 2 | 308 | 501 | 9,991 | | 3 |
| Below standard, but not impaired | 2 | 663 | 745 | 2,390 | | 1 |
| Total loans and advances which are neither past due nor impaired | 25,219 | 318,668 | 36,789 | 110,093 | 465,550 | 29,443 |
| At 31 December 2012[1] | | | | | | |
| Good quality | 32,173 | 313,372 | 30,924 | 60,510 | | 14,514 |
| Satisfactory quality | 174 | 4,532 | 8,579 | 33,477 | | 28 |
| Lower quality | 10 | 552 | 862 | 18,153 | | 6 |
| Below standard, but not impaired | 369 | 1,157 | 858 | 5,473 | | 3 |
| Total loans and advances which are neither past due nor impaired | 32,726 | 319,613 | 41,223 | 117,613 | 478,449 | 14,551 |

[1] Restated – see note 1.

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Further information about the Group's internal probabilities of default rating models can be found on page 60.

LOANS AND ADVANCES WHICH ARE PAST DUE BUT NOT IMPAIRED

| | Loans and advances to banks £m | Loans and advances to customers Retail – mortgages £m | Retail – other £m | Wholesale £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | |
| 0-30 days | 146 | 5,596 | 489 | 347 | 6,432 | – |
| 30-60 days | – | 2,639 | 87 | 102 | 2,828 | – |
| 60-90 days | – | 1,734 | 4 | 57 | 1,795 | – |
| 90-180 days | – | 2,360 | – | 41 | 2,401 | – |
| Over 180 days | – | – | – | 239 | 239 | – |
| Total loans and advances which are past due but not impaired | 146 | 12,329 | 580 | 786 | 13,695 | – |
| At 31 December 2012 | | | | | | |
| 0-30 days | – | 5,996 | 744 | 860 | 7,600 | – |
| 30-60 days | 3 | 2,667 | 138 | 131 | 2,936 | – |
| 60-90 days | 2 | 1,750 | 29 | 328 | 2,107 | – |
| 90-180 days | 6 | 2,467 | 5 | 56 | 2,528 | – |
| Over 180 days | 20 | – | 6 | 152 | 158 | – |
| Total loans and advances which are past due but not impaired | 31 | 12,880 | 922 | 1,527 | 15,329 | – |

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

DEBT SECURITIES CLASSIFIED AS LOANS AND RECEIVABLES

An analysis by credit rating of the Group's debt securities classified as loans and receivables is provided below:

| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | | |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 1 | – | 172 | 160 | – | – | 333 |
| Other asset-backed securities | 265 | 58 | 203 | 79 | 117 | 18 | 740 |
| | 266 | 58 | 375 | 239 | 117 | 18 | 1,073 |
| Corporate and other debt securities | 150 | 25 | – | – | – | 232 | 407 |
| Gross exposure | 416 | 83 | 375 | 239 | 117 | 250 | 1,480 |
| Allowance for impairment losses | | | | | | | (125 ) |
| Total debt securities classified as loans and receivables | | | | | | | 1,355 |
| At 31 December 2012 | | | | | | | |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 637 | 1,109 | 877 | 745 | 368 | 191 | 3,927 |
| Other asset-backed securities | 541 | 57 | 199 | 107 | 245 | 1 | 1,150 |
| | 1,178 | 1,166 | 1,076 | 852 | 613 | 192 | 5,077 |
| Corporate and other debt securities | 150 | – | – | – | – | 252 | 402 |
| Gross exposure | 1,328 | 1,166 | 1,076 | 852 | 613 | 444 | 5,479 |
| Allowance for impairment losses | | | | | | | (206 ) |
| Total debt securities classified as loans and receivables | | | | | | | 5,273 |

AVAILABLE-FOR-SALE FINANCIAL ASSETS (EXCLUDING EQUITY SHARES)

An analysis of the Group's available-for-sale financial assets is included in note 25. The credit quality of the Group's available-for-sale financial assets (excluding equity shares) is set out below:

| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | | |
| Debt securities: | | | | | | | |
| Government securities | 31,623 | 6,667 | – | – | – | – | 38,290 |
| Bank and building society certificates of deposit | – | 163 | 45 | – | – | – | 208 |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 911 | 115 | 25 | 130 | 82 | – | 1,263 |
| Other asset-backed securities | 557 | 226 | 107 | – | 25 | – | 915 |
| | 1,468 | 341 | 132 | 130 | 107 | – | 2,178 |
| Corporate and other debt securities | 1,083 | 174 | 191 | 351 | 37 | 19 | 1,855 |
| **Total debt securities** | 34,174 | 7,345 | 368 | 481 | 144 | 19 | 42,531 |
| Treasury bills and other bills | 15 | 852 | 8 | – | – | – | 875 |
| Total held as available-for-sale financial assets | 34,189 | 8,197 | 376 | 481 | 144 | 19 | 43,406 |
| At 31 December 2012 | | | | | | | |
| Debt securities: | | | | | | | |
| Government securities | 18,227 | 7,328 | – | – | – | – | 25,555 |
| Bank and building society certificates of deposit | – | 75 | 71 | 42 | – | – | 188 |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 976 | 212 | 50 | 120 | 166 | – | 1,524 |
| Other asset-backed securities | 336 | 241 | 116 | – | 67 | – | 760 |
| | 1,312 | 453 | 166 | 120 | 233 | – | 2,284 |
| Corporate and other debt securities | 293 | 281 | 567 | 600 | 85 | 22 | 1,848 |
| Total debt securities | 19,832 | 8,137 | 804 | 762 | 318 | 22 | 29,875 |
| Treasury bills and other bills | 866 | – | 16 | 89 | – | – | 971 |
| Total held as available-for-sale financial assets | 20,698 | 8,137 | 820 | 851 | 318 | 22 | 30,846 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

DEBT SECURITIES, TREASURY AND OTHER BILLS HELD AT FAIR VALUE THROUGH PROFIT OR LOSS

An analysis of the Group's trading and other financial assets at fair value through profit or loss is included in note 17. The credit quality of the Group's debt securities, treasury and other bills held at fair value through profit or loss is set out below:

| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | | |
| Debt securities, treasury and other bills held at fair value through profit or loss | | | | | | | |
| Trading assets: | | | | | | | |
| Government securities | 3,985 | 274 | – | – | – | – | 4,259 |
| Other public sector securities | 14 | – | – | – | – | – | 14 |
| Bank and building society certificates of deposit | – | 787 | 704 | – | – | – | 1,491 |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | – | – | – | – | 5 | – | 5 |
| Other asset-backed securities | 87 | 31 | 23 | 17 | 13 | – | 171 |
| | 87 | 31 | 23 | 17 | 18 | – | 176 |
| Corporate and other debt securities | 489 | 168 | 843 | 386 | 29 | 14 | 1,929 |
| Total debt securities held as trading assets | 4,575 | 1,260 | 1,570 | 403 | 47 | 14 | 7,869 |
| Treasury bills and other bills | 6 | 55 | – | – | – | – | 61 |
| Total held as trading assets | 4,581 | 1,315 | 1,570 | 403 | 47 | 14 | 7,930 |
| Other assets held at fair value through profit or loss: | | | | | | | |
| Government securities | 5,572 | 10,284 | 382 | 177 | 1 | 14 | 16,430 |
| Other public sector securities | 1,962 | 195 | 26 | – | – | – | 2,183 |
| Bank and building society certificates of deposit | – | – | – | – | – | – | – |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 99 | 176 | 331 | 187 | – | – | 793 |
| Other asset-backed securities | 240 | 188 | 224 | 103 | 1 | – | 756 |
| | 339 | 364 | 555 | 290 | 1 | – | 1,549 |
| Corporate and other debt securities | 383 | 2,619 | 7,462 | 5,886 | 617 | 1,724 | 18,691 |
| Total debt securities held at fair value through profit or loss | 8,256 | 13,462 | 8,425 | 6,353 | 619 | 1,738 | 38,853 |
| Treasury bills and other bills | 54 | – | – | – | – | – | 54 |
| | 8,310 | 13,462 | 8,425 | 6,353 | 619 | 1,738 | 38,907 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Total other assets held at fair value through profit or loss | | | | | | | |
| Total held at fair value through profit or loss | 12,891 | 14,777 | 9,995 | 6,756 | 666 | 1,752 | 46,837 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| At 31 December 2012[1] | | | | | | | |
| Debt securities, treasury and other bills held at fair value through profit or loss | | | | | | | |
| Trading assets: | | | | | | | |
| Government securities | 3,688 | 277 | – | – | – | – | 3,965 |
| Bank and building society certificates of deposit | – | 2,182 | 907 | 77 | – | – | 3,166 |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 42 | 10 | 78 | – | – | – | 130 |
| Other asset-backed securities | 2 | 14 | 4 | 1 | – | – | 21 |
| | 44 | 24 | 82 | 1 | – | – | 151 |
| Corporate and other debt securities | 385 | 148 | 330 | 278 | 30 | 1 | 1,172 |
| Total debt securities held as trading assets | 4,117 | 2,631 | 1,319 | 356 | 30 | 1 | 8,454 |
| Treasury bills and other bills | 370 | 4 | – | – | – | – | 374 |
| Total held as trading assets | 4,487 | 2,635 | 1,319 | 356 | 30 | 1 | 8,828 |
| Other assets held at fair value through profit or loss: | | | | | | | |
| Government securities | 15,213 | 1,588 | 204 | 362 | 1 | 12 | 17,380 |
| Other public sector securities | 694 | 205 | 131 | 6 | – | 20 | 1,056 |
| Bank and building society certificates of deposit | – | 94 | 134 | – | – | – | 228 |
| Asset-backed securities: | | | | | | | |
| Mortgage-backed securities | 236 | 95 | 309 | 125 | 22 | 8 | 795 |
| Other asset-backed securities | 251 | 394 | 792 | 386 | 22 | 47 | 1,892 |
| | 487 | 489 | 1,101 | 511 | 44 | 55 | 2,687 |
| Corporate and other debt securities | 3,198 | 2,836 | 8,021 | 7,647 | 2,866 | 1,819 | 26,387 |
| Total debt securities held at fair value through profit or loss | 19,592 | 5,212 | 9,591 | 8,526 | 2,911 | 1,906 | 47,738 |
| Treasury bills and other bills | 56 | – | – | – | – | – | 56 |
| Total other assets held at fair value through profit or loss | 19,648 | 5,212 | 9,591 | 8,526 | 2,911 | 1,906 | 47,794 |
| Total held at fair value through profit or loss | 24,135 | 7,847 | 10,910 | 8,882 | 2,941 | 1,907 | 56,622 |

[1]Restated – see note 1.

Credit risk in respect of trading and other financial assets at fair value through profit or loss held within the Group's unit-linked funds is borne by the policyholders and credit risk in respect of with-profits funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back those contract liabilities.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

DERIVATIVE ASSETS

An analysis of derivative assets is given in note 18. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £13,646 million (2012: £18,399 million), cash collateral of £3,188 million (2012: £5,429 million) was held and a further £2,372 million was due from OECD banks (2012: £1,387 million).

| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | | |
| Trading and other | 298 | 4,719 | 13,300 | 4,209 | 2,554 | 1,258 | 26,338 |
| Hedging | – | 2,936 | 3,687 | 127 | 32 | 5 | 6,787 |
| Total derivative financial instruments | 298 | 7,655 | 16,987 | 4,336 | 2,586 | 1,263 | 33,125 |
| At 31 December 2012 | | | | | | | |
| Trading and other | 226 | 13,507 | 18,137 | 5,046 | 6,439 | 1,631 | 44,986 |
| Hedging | – | 6,038 | 4,596 | 111 | 824 | 2 | 11,571 |
| Total derivative financial instruments | 226 | 19,545 | 22,733 | 5,157 | 7,263 | 1,633 | 56,557 |

ASSETS ARISING FROM REINSURANCE CONTRACTS HELD

Of the assets arising from reinsurance contracts held at 31 December 2013 of £732 million (2012: £2,320 million), £383 million (2012: £764 million) were due from insurers with a credit rating of AA or above.

FINANCIAL GUARANTEES AND IRREVOCABLE LOAN COMMITMENTS

Financial guarantees represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

**C. COLLATERAL HELD AS SECURITY FOR FINANCIAL ASSETS**

A general description of collateral held as security in respect of financial instruments is provided on page 62. The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

**LOANS AND RECEIVABLES**

The disclosures below are produced under the underlying basis used for the Group's segmental reporting. The Group believes that, for reporting periods following a significant acquisition, such as the acquisition of HBOS in 2009, this underlying basis, which includes the allowance for loan losses at the acquisition on a gross basis, more fairly reflects the underlying provisioning status of the loans.

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as loans and receivables.

LOANS AND ADVANCES TO BANKS

The Group may require collateral before entering into a credit commitment with another bank, depending on the type of financial product and the counterparty involved, and netting arrangements are obtained whenever possible and to the extent that such agreements are legally enforceable. Collateral is held as part of reverse repurchase or securities borrowing transactions.

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £183 million (2012: £662 million), against which the Group held collateral with a fair value of £183 million (2012: £662 million), all of which the Group is able to repledge.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

LOANS AND ADVANCES TO CUSTOMERS

The Group holds collateral against loans and advances to customers in the form of mortgages over residential and commercial real estate, 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

*Retail lending*

*MORTGAGES*

An analysis by loan-to-value ratio of the Group's residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations.

| | Neither past due nor impaired £m | Past due but not impaired £m | Impaired £m | Gross £m |
|---|---|---|---|---|
| At 31 December 2013 | | | | |
| Less than 70 per cent | 161,105 | 4,294 | 1,743 | 167,142 |
| 70 per cent to 80 per cent | 64,954 | 2,296 | 970 | 68,220 |
| 80 per cent to 90 per cent | 46,581 | 2,224 | 1,080 | 49,885 |
| 90 per cent to 100 per cent | 24,592 | 1,720 | 1,027 | 27,339 |
| Greater than 100 per cent | 21,436 | 1,795 | 2,046 | 25,277 |
| Total | 318,668 | 12,329 | 6,866 | 337,863 |

| | Neither past due nor impaired £m | Past due but not impaired £m | Impaired £m | Gross £m |
|---|---|---|---|---|
| At 31 December 2012 | | | | |
| Less than 70 per cent | 131,277 | 3,283 | 1,470 | 136,030 |
| 70 per cent to 80 per cent | 61,677 | 1,962 | 846 | 64,485 |
| 80 per cent to 90 per cent | 52,651 | 2,314 | 1,114 | 56,079 |
| 90 per cent to 100 per cent | 36,428 | 2,092 | 1,133 | 39,653 |
| Greater than 100 per cent | 37,580 | 3,229 | 3,569 | 44,378 |
| Total | 319,613 | 12,880 | 8,132 | 340,625 |

*OTHER*

No collateral is held in respect of retail credit cards or overdrafts, or unsecured personal loans. For non-mortgage retail lending to small businesses, collateral will often include second charges over residential property and the assignment of life cover.

The majority of non-mortgage retail lending is unsecured. At 31 December 2013, impaired non-mortgage lending amounted to £1,696 million, net of an impairment allowance of £1,044 million (2012: £2,328 million, net of an impairment allowance of £1,326 million). The fair value of the collateral held in respect of this lending was £144 million (2012: £48 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group’s exposure.

Unimpaired non-mortgage retail lending amounted to £36,081 million (2012: £42,145 million). Lending decisions are predominantly based on an obligor’s ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

*Wholesale lending*

*REVERSE REPURCHASE TRANSACTIONS*

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £120 million (2012: £5,087 million), against which the Group held collateral with a fair value of £112 million (2012: £4,916 million), all of which the Group is able to repledge. Included in these amounts are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £49 million (2012: £2 million). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

*IMPAIRED SECURED LENDING*

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2013, impaired secured wholesale lending amounted to £9,845 million, net of an impairment allowance of £11,063 million (2012: £17,257 million, net of an impairment allowance of £15,193 million). The fair value of the collateral held in respect of impaired secured wholesale lending was £6,915 million (2012: £9,414 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured wholesale lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Impaired secured wholesale lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

*UNIMPAIRED SECURED LENDING*

Unimpaired secured wholesale lending amounted to £69,108 million (2012: £74,485 million). Wholesale lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgage debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor. Although lending decisions are predominantly based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted; this will have a financial impact on the amount of net interest income recognised and on internal loss-given-default estimates that contribute to the determination of asset quality.

For unimpaired secured wholesale lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

Unimpaired secured wholesale lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured wholesale lending portfolio is provided to key management personnel.

**TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS (EXCLUDING EQUITY SHARES)**

In respect of trading and other financial assets at fair value through profit or loss, the fair value of collateral accepted under reverse repurchase transactions which are accounted for as collateralised loans that the Group is permitted by contract or custom to sell or repledge was £32,434 million (2012: £19,629 million). Of this, £8,195 million was sold or repledged (2012: £15,640 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £46,552 million (2012: £38,040 million). Of this amount, £45,277 million (2012: £36,549 million) had been resold or repledged as collateral for the Group’s own transactions.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

**DERIVATIVE ASSETS, AFTER OFFSETTING OF AMOUNTS UNDER MASTER NETTING ARRANGEMENTS**

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £13,646 million (2012: £18,399 million), cash collateral of £3,188 million (2012: £5,429 million) was held.

**IRREVOCABLE LOAN COMMITMENTS AND OTHER CREDIT-RELATED CONTINGENCIES**

At 31 December 2013, the Group held irrevocable loan commitments and other credit-related contingencies of £59,172 million (2012: £55,629 million). Collateral is held as security, in the event that lending is drawn down, on £19,123 million (2012: £17,697 million) of these balances.

Lending decisions in respect of irrevocable loan commitments are based on the obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. For wholesale commitments, it is the Group's practice to request collateral whose value is commensurate with the nature of the commitment. For retail mortgage commitments, the majority are for mortgages with a loan-to-value ratio of less than 100 per cent. Aggregated collateral information covering the entire balance of irrevocable loan commitments over which security will be taken is not provided to key management personnel.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

**D. COLLATERAL PLEDGED AS SECURITY**

**REPO AND STOCK LENDING TRANSACTIONS**

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £37,999 million (2012: £48,077 million). In addition, the following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

Assets pledged

| | 2013<br>£m | 2012<br>£m |
|---|---|---|
| Trading and other financial assets at fair value through profit or loss | 9,928 | 10,000 |
| Loans and advances to customers | 14,927 | 11,603 |
| Debt securities classified as loans and receivables | 89 | 154 |
| Available-for-sale financial assets | 2,311 | 4,251 |
| | 27,255 | 26,008 |

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group’s asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 21 and 22.

**E. COLLATERAL REPOSSESSED**

| | 2013 | 2012 |
|---|---|---|
| | £m | £m |
| Residential property | 897 | 936 |
| Other | 5 | 6 |
| | 902 | 942 |

In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

## F. TREATMENT OF CUSTOMERS EXPERIENCING FINANCIAL STRESS

The Group operates a number of schemes to assist borrowers who are experiencing financial stress. The material elements of these schemes are described in the Risk Management report on pages 63 to 64 and further details relating to those cases where the Group has granted a concession, whether temporarily or permanently, are set out below.

## RETAIL CUSTOMERS

FORBEARANCE ACTIVITIES

The Group classifies the treatments offered to retail customers who have experienced financial difficulty into the following categories:

– *Reduced contractual monthly payment:* a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example temporary interest only arrangements and short-term payment holidays granted in collections. Any arrears existing at the commencement of the arrangement are retained;

– *Reduced payment arrangements:* a temporary arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay;

– *Term extensions:* a permanent account change for customers in financial distress where the overall term of the mortgage is extended resulting in a lower contractual monthly payment; and

–

*Repair:* a permanent account change used to repair a customer's position where they have emerged from financial difficulty, for example capitalisation of arrears.

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**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

CUSTOMERS RECEIVING SUPPORT FROM UK GOVERNMENT SPONSORED PROGRAMMES

The Group participates in a number of UK Government sponsored programmes designed to support households, which are described on page 63. Where these schemes provide borrowers with a state benefit that is used to service the loan, there is no change in the reported status of the loan which is managed and reported in accordance with its original terms.

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

The Income Support for Mortgage Interest scheme remains the most successful of the Government backed schemes. It is the longest-running, is the most widely known and provides both the customer and the Group with an assurance as to the maintenance of at least two years' worth of interest payments. The Group estimates that customers representing approximately £2.6 billion of its mortgage exposures are receiving this benefit. This includes those who are also receiving other treatments for financial difficulty.

CUSTOMERS IN FINANCIAL DIFFICULTY RECEIVING SUPPORT UNDER OTHER SCHEMES

The Group measures the success of a forbearance scheme based upon the proportion of customers maintaining or improving their arrears position over the 12 months following the exit from a forbearance treatment. For temporary treatments, 87 per cent of customers who have accepted temporary interest-only concessions and 75 per cent of customers accepting reduced payment arrangements have maintained or improved their arrears position. For permanent treatments, 77 per cent of customers who have accepted capitalisations of arrears and 40 per cent of customers who have accepted term extensions have maintained or improved their arrears position.

FORBEARANCE IDENTIFICATION AND CLASSIFICATION

The Group has applied revised forbearance definitions based upon principles developed through the British Bankers' Association. As a result of this, forbearance data for 2012 has been restated to reflect the new definitions. The restated data for 2012 shows overall forbearance balances to be higher than previous financial statements as the balances now include accounts which are no longer on a forbearance treatment, but where the exposure is known to be, or may still be, in financial difficulty.

The Group classifies a retail account as forborne at the time a customer in financial difficulty is granted a concession. Accounts are classified as forborne only for the period of time which the exposure is known to be, or may still be, in financial difficulty. Where temporary forbearance is granted, exit criteria are applied to include accounts until they are known to no longer be in financial difficulty. Details of the exit criteria are shown in the analysis below. Where the treatment involves a permanent change to the contractual basis of the customer's account such as a capitalisation of arrears or term extension, the Group classifies the balance as forborne for a period of 24 months, after which no distinction is made between these accounts and others where no change has been made.

*Secured retail lending –UK*

At 31 December 2013, retail secured loans and advances currently or recently subject to forbearance were 2.0 per cent (31 December 2012: 2.9 per cent) of total retail secured loans and advances. The Group no longer offers temporary interest only as a forbearance treatment to secured lending customers in financial difficulty, which is the primary driver of the reduction in forbearance balances in 2013. Further analysis of the forborne loan balances is set out below:

| | Total loans and advances which are currently or recently forborne | | Total current and recent forborne loans and advances which are impaired[1] | | Impairment provisions as % of loans and advances which are currently or recently forborne | |
|---|---|---|---|---|---|---|
| | 2013 £m | 2012[2] £m | 2013 £m | 2012[2] £m | 2013 % | 2012[2] % |
| At 31 December | | | | | | |
| Temporary forbearance arrangements | | | | | | |
| Reduced contractual monthly payment[3] | 995 | 4,514 | 226 | 538 | 4.0 | 2.5 |
| Reduced payment arrangements[4] | 1,376 | 1,412 | 160 | 320 | 3.2 | 4.0 |
| | 2,371 | 5,926 | 386 | 858 | 3.5 | 2.8 |
| Permanent treatments | | | | | | |
| Repair and term extensions[5] | 4,008 | 3,565 | 305 | 289 | 3.4 | 3.9 |
| Total | 6,379 | 9,491 | 691 | 1,147 | 3.4 | 3.2 |
| | | | | | | |
| Included in the total above: | | | | | | |
| Temporary arrangements currently on treatment | 1,100 | 3,103 | 179 | 516 | 3.4 | 3.7 |
| Permanent treatments within last 12 months | 2,187 | 1,913 | 78 | 90 | 3.1 | 4.3 |

1 £5,688 million of current and recent forborne loans and advances were not impaired at 31 December 2013 (31 December 2012: £8,344 million).

2 Restated to reflect the change in forbearance probation periods. Previously only temporary arrangements in place at the year end and permanent changes commenced during the year were shown.

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

4 Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.

5 Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and remaining as customers at the year end.

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**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

*Collective impairment assessment of retail secured loans subject to forbearance*

Loans which are forborne are grouped with other assets with similar risk characteristics and assessed collectively for impairment as described below. The loans are not considered as impaired loans unless they meet the Group's definition of an impaired asset.

The Group's approach is to ensure that provisioning models, supported by management judgement, appropriately reflect the underlying loss risk of exposures. The Group uses sophisticated behavioural scoring to assess customers' credit risk. The underlying behavioural scorecards consider many different characteristics of customer behaviour, both static and dynamic, from internal sources and also from credit bureaux data, including characteristics that may identify when a customer has been in arrears on products held with other firms. Hence, these models take a range of potential indicators of customer financial distress into account.

The performance of such models is monitored and challenged on an ongoing basis, in line with the Group's model governance policies. The models are also regularly recalibrated to reflect up to date customer behaviour and market conditions. Specifically, regular detailed analysis of modelled provision outputs is undertaken to demonstrate that the risk of forbearance or other similar activities is recognised, that the outcome period adequately captures the risk and that the underlying risk is appropriately reflected. Where this is not the case, additional provisions are applied to capture the risk.

*Unsecured retail lending – UK*

At 31 December 2013, UK retail unsecured loans and advances currently or recently subject to forbearance were 2.6 per cent (31 December 2012: 3.9 per cent) of total UK retail unsecured loans and advances of £21,566 million (31 December 2012: £22,698 million). Further analysis of the forborne loan balances is set out below:

| | Total loans and advances which are currently or recently forborne | **Total current and recent forborne loans and advances which are impaired**[1] | Impairment provisions as % of loans and advances which are currently or recently forborne |
|---|---|---|---|

| | 2013 £m | 2012[2] £m | 2013 £m | 2012[2] £m | 2013 % | 2012[2] % |
|---|---|---|---|---|---|---|
| Temporary forbearance arrangements | | | | | | |
| Reduced contractual monthly payment[3] | 260 | 339 | 230 | 324 | 39.2 | 48.8 |
| Reduced payment arrangements[4] | 104 | 194 | 86 | 150 | 51.7 | 49.3 |
| | 364 | 533 | 316 | 474 | 42.8 | 49.0 |
| Permanent treatments | | | | | | |
| Repair and term extensions[5] | 201 | 350 | 79 | 176 | 9.9 | 10.4 |
| Total | 565 | 883 | 395 | 650 | 31.1 | 33.7 |
| | | | | | | |
| Included in the total above: | | | | | | |
| Temporary arrangements currently on treatment | 265 | 388 | 262 | 383 | 45.0 | 51.6 |
| Permanent treatments within last 12 months | 90 | 208 | 38 | 110 | 13.2 | 11.8 |

1 £170 million of current and recent forborne loans and advances were not impaired at 31 December 2013 (31 December 2012: £233 million).

2 Restated to reflect the change in forbearance probation periods. Previously only temporary arrangements in place at the year end and permanent changes commenced during the year were shown.

3 Includes repayment plans and short-term payment holidays granted in collections where the customer is currently benefitting from the treatment and where the concession has ended within the previous six months.

4 Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous six months.

5 Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and remaining as customers at the year end.

*Collective impairment assessment of UK retail unsecured loans and advances subject to forbearance*

Credit risk provisioning for the UK retail unsecured portfolio is undertaken on a purely collective basis. The approach used is based on segmented cash flow models, divided into two primary streams for loans judged to be impaired and those that are not. Accounts subject to repayment plans and collections refinance loans are among those considered to be impaired.

For exposures that are judged to be impaired, provisions are determined through modelling the expected cure rates, write-off propensity and cash flows with segments explicitly relating to repayment plans and refinance loans treatments. Payments of less than the monthly contractual amount are reflected in reduced cash flow forecasts when calculating the impairment allowance for these accounts.

The outputs of the models are monitored and challenged on an ongoing basis. The models are run monthly meaning that current market conditions and customer processes are reflected in the output. Where the risks identified are not captured in the underlying models, appropriate additional provisions are made.

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notes to the consolidated financial statements

**Note 54: Financial risk management** continued

*Secured retail lending – Ireland*

At 31 December 2013, Irish secured loans and advances subject to current or recent forbearance were 12.2 per cent (31 December 2012: 12.3 per cent) of total Irish retail secured loans and advances. Further analysis of the forborne loan balances is set out below:

| | **Total loans and advances which are currently or recently forborne** | | **Total current and recent forborne loans and advances which are impaired**[1] | | **Impairment provisions as % of loans and advances which are currently or recently forborne** | |
|---|---|---|---|---|---|---|
| | **2013 £m** | 2012[2] £m | **2013 £m** | 2012[2] £m | **2013 %** | 2012[2] % |
| At 31 December | | | | | | |
| Temporary forbearance arrangements | | | | | | |
| Reduced contractual monthly payment | **–** | – | **–** | – | **–** | – |
| Reduced payment arrangements[3] | **254** | 385 | **227** | 336 | **49.8** | 45.2 |
| | **254** | 385 | **227** | 336 | **49.8** | 45.2 |
| Permanent treatments | | | | | | |
| Repair and term extensions[4] | **473** | 430 | **102** | 71 | **14.4** | 27.9 |
| **Total** | **727** | 815 | **329** | 407 | **26.7** | 36.1 |
| | | | | | | |
| Included in the total above: | | | | | | |
| Temporary arrangements currently on treatment | **224** | 300 | **43** | 32 | **13.9** | 30.1 |
| Permanent treatments within last 12 months | **196** | 272 | **174** | 232 | **50.0** | 44.5 |

1 £398 million of current and recent forborne loans and advances were not impaired at 31 December 2013 (31 December 2012: £408 million).

2 The 2012 numbers have been restated to reflect the change in forbearance probation periods. Previously only temporary arrangements in place at the year end and permanent changes commenced during the year were shown.

3 Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.

4 Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and remaining as customers at the year end.

**ASSET FINANCE RETAIL LENDING**

Asset Finance operates a number of retail portfolios including Black Horse Motor Finance as well as a number of portfolios closed to new business and currently in run-off. The reduction in the level of forborne loans in 2013 was driven by the continuing run-off and sale of portfolios which are outside of the Group's risk appetite. The table below includes both the open and closed retail portfolios in the Asset Finance business. For temporary forbearance arrangements, it includes accounts that are currently on a forbearance treatment. For permanent forbearance treatments, it includes capitalisation of arrears which commenced during the previous 12 months.

| | **Total loans and advances which are forborne** | | **Total forborne loans and advances which are impaired[1]** | | **Impairment provisions as % of loans and advances which are forborne** | |
|---|---|---|---|---|---|---|
| | **2013 £m** | 2012 £m | **2013 £m** | 2012 £m | **2013 %** | 2012 % |
| At 31 December | | | | | | |
| Reduced contractual monthly payment | **209** | 328 | **192** | 301 | **62.8** | 58.0 |
| Reduced payment arrangements | **63** | 112 | **56** | 102 | **24.9** | 24.8 |
| Repair | **5** | 7 | **1** | 2 | **2.3** | 1.6 |
| Total | **277** | 447 | **249** | 405 | **53.2** | 48.8 |

[1] £28 million of forborne loans and advances were not impaired at 31 December 2013 (31 December 2012: £42 million).

**COMMERCIAL CUSTOMERS**

FORBEARANCE

A key factor in determining whether the Group treats a commercial customer as forborne is the granting of a concession to a borrower who is in financial difficulty.

Loans that have been renegotiated and/or restructured for solely commercial reasons, where there is no financial difficulty would not be treated as forborne. The Group does not believe the concept of forbearance attaches to the trading book where assets are marked to market daily.

The Group recognises that forbearance alone is not necessarily an indicator of impaired status but is a trigger for the review of the customer's credit profile. The Group grants forbearance when it believes that there is a realistic prospect of the customer continuing to be able to repay all facilities in full. If there is any concern over future cash flows and the Group incurring a loss, then forborne loans will be classified as impaired in accordance with the Group's impairment policy.

Recovery can sometimes be through improvement in market or economic conditions, or the customer may benefit from access to alternative sources of liquidity such as an equity injection. These can be especially relevant in real estate or other asset backed transactions where a fire sale of assets in a weak market may be unattractive.

Depending on circumstances and when operated within robust parameters and controls, the Group believes forbearance can help support the customer in the short to medium-term.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

Therefore the Group expects to have unimpaired forborne assets within its portfolios, although as noted below, these are specifically controlled and managed. Unimpaired forborne assets are included in calculating the overall collective unimpaired provision, and which uses the historical observed default rate of the portfolio as a whole as part of its calculation.

Types of forbearance

Forbearance treatments may include changes to:

– Contractual payment terms (for example loan extensions, or changes to debt servicing terms), and

– Non-payment contractual terms (for example covenant amendments or waivers) where the modifications enable default to be avoided.

The four main types of forbearance concessions to commercial customers in financial difficulty are set out below:

– Covenants: This includes temporary and permanent waivers, amendment or resetting of non-payment contractual covenants (including LTV and interest cover). The granting of this type of concession in itself would not result in the loan being classified as impaired;

– Extensions/Alterations: This includes extension and/or alteration of repayment terms to a level outside of market or the Group’s risk appetite due to the customer’s inability to make existing contractual repayment terms; amendments to an interest rate to a level considered outside of market or the Group’s risk appetite, or other amendments such as changes to debt servicing arrangements;

– Forgiveness: This includes debt for equity swaps or partial debt forgiveness. This type of forbearance will always give rise to impairment; and

– Multiple type of forbearance (a mixture of the above three). Where a concession is granted to a customer that is not in financial difficulty or the risk profile is considered within current risk appetite, the concession would not be considered to be an act of forbearance.

A number of options are available to the Group where a customer is facing financial difficulty, and each case is treated depending on its own specific circumstances.

The Group’s strategy and offer of forbearance is largely dependent on the individual situation and early identification, control and monitoring are key in order to support the customer and protect the Group. Concessions are often provided to help the customer with their day to day liquidity and working capital.

FORBEARANCE IDENTIFICATION AND CLASSIFICATION

The Group’s policy is to treat all impaired assets in Commercial Banking as having been granted some form of forbearance. Impaired loans and advances exist only in Business Support; Global Non Core; and, for smaller SME customers, Customer Support. Unimpaired forborne loans and advances exist in the good book, in Business Support and in Global Non Core.

All non-retail loans and advances in Commercial Banking are reviewed at least annually by the independent Risk Division. As part of our long established Credit Risk Classification system, every loan and advance in the good book is categorised as either ‘good’ or ‘watchlist’.

The watchlist is further categorised depending on the current and expected credit risk attaching to the customer and the transaction. All watchlist names are reviewed by the Business and Risk at least once a month, and the classification is updated if required.

Any concession granted to a customer is reviewed and must be approved by the independent Risk Division. If Risk Division determines that the customer is in financial difficulty, then any off-market concession granted is treated as forbearance and the loan reviewed monthly. Forbearance does not arise if the customer is not in financial difficulty or if the risk profile of the customer following the concession is within the Group’s current risk appetite.

Any event that causes concern over future payments from the customer is likely to result in the asset being assessed for impairment and, if required, an impairment allowance recognised. If impairment is identified, the customer is immediately transferred to Business Support and the lending will be treated as an impaired asset. If no impairment is identified, the Risk Division will determine if the customer should remain in the good book (categorised as watchlist), or transfer to Business Support for more intensive monitoring.

All reviews performed in the good book, Business Support or Global Non Core include analysis of latest financial information, a consideration of the market and sector the customer operates in, performance against plan and revised terms and conditions granted as part of the forbearance concession.

EXIT FROM FORBEARANCE CLASSIFICATION

A customer where forbearance has been granted will remain treated and recorded as forborne until it evidences acceptable performance over a period of time. This period will depend on a number of factors such as whether the customer is trading in line with its revised plan, it is operating within the new terms and conditions (including observation to revised covenants and contractual payments), its financial performance is stable or improving, and there are no undue concerns over its future performance. As a minimum, this period is currently expected to be at least 12 months following a forbearance event (during 2014, the minimum cure period will be reviewed again in conjunction with regulatory requirements). However, notwithstanding this, the overriding requirement is that the financial difficulty previously seen has been removed, and the performance has stabilised.

Once a customer evidences acceptable performance over a period of time, the Group would expect that it could be returned to the mainstream good classification and they would no longer be considered forborne. It is important to note that such a decision can be made only by the independent Risk Division.

Currently, the exception to this 12 month minimum period is where a permanent structural cure is made (for example, this could be an injection of new collateral security or partial repayment of debt to restore an LTV back to within the covenant). In this case, the customer may be removed from the forbearance category once the permanent cure has been made.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**Note 54: Financial risk management** continued

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

| | **Total loans and advances which are forborne** | | **Impairment provisions as % of loans and advances which are forborne** | |
|---|---|---|---|---|
| | **2013** | 2012 | **2013** | 2012 |
| | **£m** | £m | % | % |
| Impaired | 14,714 | 23,965 | 43.6 | 41.7 |
| Unimpaired | 6,221 | 9,027 | – | – |
| Total | 20,935 | 32,992 | 30.6 | 30.3 |

All impaired assets are considered forborne. At 31 December 2013, £6,221 million (31 December 2012: £9,027 million) of its unimpaired assets are also considered forborne as a result of proactive management of cases to help customers in financial difficulties. Of this figure, £3,789 million was classified as being outside of the Group's risk appetite.

The table below sets out the Group's largest unimpaired forborne loans and advances to commercial customers (exposures over £5 million) as at 31 December 2013 by type of forbearance, together with a breakdown on which exposures are classified as Direct Real Estate:

| | Direct Real Estate | Other industry sector | Total |
|---|---|---|---|
| | £m | £m | £m |
| At 31 December 2013 | | | |
| Type of unimpaired forbearance | | | |
| UK exposures[1] > £5 million | | | |
| Covenants | 1,555 | 842 | 2,397 |
| Extensions | 200 | 343 | 543 |
| Multiple | 23 | 380 | 403 |
| | 1,778 | 1,565 | 3,343 |

| | |
|---|---|
| Exposures < £5 million and other non-UK | 2,878 |
| Total | 6,221 |

[1] Based on the location of the office recording the transaction.

*Ireland wholesale (part of Wealth, Asset Finance and International division)*

All loans and advances in Ireland wholesale (whether impaired or unimpaired) are treated as forborne and all assets are classified as being outside of the Group's risk appetite.

| | Total loans and advances which are forborne | | Impairment provisions as % of loans and advances which are forborne | |
|---|---|---|---|---|
| | **2013** | 2012 | **2013** | 2012 |
| | **£m** | £m | **%** | % |
| Impaired | 8,322 | 10,967 | 73.1 | 68.0 |
| Unimpaired | 1,108 | 1,908 | – | – |
| Total | 9,430 | 12,875 | 64.5 | 58.0 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

**LIQUIDITY RISK**

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group’s liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses assets and liabilities of the Group into relevant maturity groupings based on the remaining contractual period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

**MATURITIES OF ASSETS AND LIABILITIES**

| | Up to 1 month | 1-3 months | 3-6 months | 6-9 months | 9-12 months | 1-2 years | 2-5 years | Over 5 years | Total |
|---|---|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| **At 31 December 2013** | | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances at central banks | 49,823 | 5 | 78 | – | – | – | – | 9 | 49,915 |
| Trading and other financial assets at fair value through profit or loss | 15,874 | 6,966 | 5,868 | 3,892 | 2,630 | 5,601 | 2,989 | 98,863 | 142,683 |
| Derivative financial instruments | 567 | 1,022 | 858 | 780 | 582 | 2,420 | 6,938 | 19,958 | 33,125 |
| Loans and advances to banks | 11,853 | 5,980 | 3,310 | 553 | 1,038 | 344 | 1,827 | 460 | 25,365 |
| Loans and advances to customers | 35,006 | 6,720 | 9,699 | 10,269 | 11,886 | 25,191 | 56,156 | 340,354 | 495,281 |
| Debt securities held as loans and receivables | – | 150 | 10 | – | – | 41 | 66 | 1,088 | 1,355 |
| Available-for-sale financial assets | 139 | 642 | 26 | 390 | 142 | 1,933 | 2,932 | 37,772 | 43,976 |
| Other assets | 6,265 | 9,083 | 1,491 | 663 | 1,610 | 2,665 | 7,900 | 25,653 | 55,330 |
| **Total assets** | 119,527 | 30,568 | 21,340 | 16,547 | 17,888 | 38,195 | 78,808 | 524,157 | 847,030 |
| **Liabilities** | | | | | | | | | |
| Deposits from banks | 9,984 | 612 | 291 | 788 | 116 | 1,548 | 113 | 530 | 13,982 |
| Customer deposits | 337,130 | 16,034 | 18,659 | 13,562 | 11,224 | 26,749 | 16,592 | 1,361 | 441,311 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss | **19,321** | **12,458** | **3,974** | **2,165** | **1,414** | **5,029** | **9,182** | **20,546** | **74,089** |
| Debt securities in issue | **5,427** | **5,771** | **6,399** | **3,644** | **4,081** | **12,184** | **18,857** | **30,739** | **87,102** |
| Liabilities arising from insurance and investment contracts | **1,486** | **6,579** | **2,317** | **2,244** | **3,046** | **8,430** | **21,300** | **65,356** | **110,758** |
| Other liabilities | **7,679** | **6,043** | **1,230** | **374** | **1,045** | **1,146** | **1,814** | **28,809** | **48,140** |
| Subordinated liabilities | **363** | **238** | **800** | **718** | **645** | **2,710** | **5,813** | **21,025** | **32,312** |
| **Total liabilities** | **381,390** | **47,735** | **33,670** | **23,495** | **21,571** | **57,796** | **73,671** | **168,366** | **807,694** |
| At 31 December 2012 | | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances at central banks | 80,035 | 259 | 4 | – | – | – | – | – | 80,298 |
| Trading and other financial assets at fair value through profit or loss | 7,949 | 9,813 | 2,710 | 1,386 | 1,383 | 1,748 | 5,368 | 130,263 | 160,620 |
| Derivative financial instruments | 2,450 | 938 | 1,063 | 817 | 864 | 3,761 | 13,982 | 32,682 | 56,557 |
| Loans and advances to banks | 18,167 | 6,513 | 2,830 | 389 | 455 | 437 | 3,291 | 675 | 32,757 |
| Loans and advances to customers | 44,781 | 8,718 | 9,850 | 9,328 | 11,874 | 27,393 | 64,428 | 340,853 | 517,225 |
| Debt securities held as loans and receivables | 153 | – | – | 22 | – | 203 | 236 | 4,659 | 5,273 |
| Available-for-sale financial assets | 565 | 130 | 558 | 32 | 174 | 241 | 4,168 | 25,506 | 31,374 |
| Other assets | 5,394 | 463 | 1,008 | 564 | 485 | 159 | 360 | 41,684 | 50,117 |
| Total assets | 159,494 | 26,834 | 18,023 | 12,538 | 15,235 | 33,942 | 91,833 | 576,322 | 934,221 |
| **Liabilities** | | | | | | | | | |
| Deposits from banks | 14,131 | 3,212 | 9,682 | 297 | 1,317 | 2,981 | 5,454 | 1,331 | 38,405 |
| Customer deposits | 322,788 | 14,159 | 14,144 | 11,471 | 12,242 | 24,319 | 26,270 | 1,519 | 426,912 |
| Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss | 12,818 | 5,556 | 8,005 | 2,875 | 1,963 | 4,630 | 15,534 | 30,687 | 82,068 |
| Debt securities in issue | 13,912 | 10,505 | 4,242 | 3,422 | 4,503 | 16,130 | 30,244 | 34,295 | 117,253 |
| Liabilities arising from insurance and investment contracts | 27,230 | 1,469 | 1,789 | 1,707 | 1,774 | 5,983 | 14,693 | 82,947 | 137,592 |
| Other liabilities | 10,171 | 298 | 567 | 75 | 929 | 618 | 745 | 41,915 | 55,318 |
| Subordinated liabilities | 402 | 1,541 | – | – | 294 | 1,043 | 7,255 | 23,557 | 34,092 |
| Total liabilities | 401,452 | 36,740 | 38,429 | 19,847 | 23,022 | 55,704 | 100,185 | 216,251 | 891,640 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

The above tables are provided on a contractual basis. The Group's assets and liabilities may be repaid or otherwise mature earlier or later than implied by their contractual terms and readers are, therefore, advised to use caution when using this data to evaluate the Group's liquidity position. In particular, amounts in respect of customer deposits are usually contractually payable on demand or at short notice. However, in practice, these deposits are not usually withdrawn on their contractual maturity.

The table below analyses financial instrument liabilities of the Group, excluding those arising from insurance and participating investment contracts, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

| | **Up to 1 month £m** | **1-3 months £m** | **3-12 months £m** | **1-5 years £m** | **Over 5 years £m** | **Total £m** |
|---|---|---|---|---|---|---|
| **At 31 December 2013** | | | | | | |
| Deposits from banks | **9,944** | **636** | **1,254** | **1,710** | **738** | **14,282** |
| Customer deposits | **322,931** | **15,576** | **38,689** | **43,011** | **34,510** | **454,717** |
| Trading and other financial liabilities at fair value through profit or loss | **18,811** | **9,906** | **4,416** | **7,382** | **3,616** | **44,131** |
| Debt securities in issue | **7,427** | **5,069** | **15,805** | **40,928** | **24,514** | **93,743** |
| Liabilities arising from non-participating investment contracts | **27,590** | **–** | **–** | **–** | **–** | **27,590** |
| Subordinated liabilities | **180** | **424** | **2,503** | **15,019** | **24,538** | **42,664** |
| **Total non-derivative financial liabilities** | **386,883** | **31,611** | **62,667** | **108,050** | **87,916** | **677,127** |
| Derivative financial liabilities: | | | | | | |
| Gross settled derivatives – outflows | **4,880** | **81,612** | **35,369** | **56,857** | **33,767** | **212,485** |
| Gross settled derivatives – inflows | **(4,115)** | **(79,256)** | **(34,321)** | **(55,396)** | **(32,625)** | **(205,713)** |
| Gross settled derivatives – net flows | **765** | **2,356** | **1,048** | **1,461** | **1,142** | **6,772** |
| Net settled derivatives liabilities | **21,730** | **179** | **438** | **1,202** | **541** | **24,090** |
| **Total derivative financial liabilities** | **22,495** | **2,535** | **1,486** | **2,663** | **1,683** | **30,862** |
| At 31 December 2012 | | | | | | |
| Deposits from banks | 13,858 | 3,556 | 11,187 | 8,566 | 1,382 | 38,549 |
| Customer deposits | 323,925 | 14,928 | 39,298 | 51,043 | 1,579 | 430,773 |
| Trading and other financial liabilities at fair value through profit or loss | 11,622 | 4,720 | 7,874 | 6,931 | 3,764 | 34,911 |
| Debt securities in issue | 14,186 | 10,890 | 16,223 | 63,851 | 27,451 | 132,601 |
| Liabilities arising from non-participating investment contracts | 27,205 | – | – | – | 27,167 | 54,372 |
| Subordinated liabilities | 61 | 1,768 | 1,705 | 15,903 | 30,032 | 49,469 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total non-derivative financial liabilities | 390,857 | 35,862 | 76,287 | 146,294 | 91,375 | 740,675 |
| Derivative financial liabilities: | | | | | | |
| Gross settled derivatives – outflows | 2,331 | 3,243 | 7,097 | 51,424 | 33,678 | 97,773 |
| Gross settled derivatives – inflows | (2,026) | (2,790) | (6,853) | (50,384) | (32,145) | (94,198) |
| Gross settled derivatives – net flows | 305 | 453 | 244 | 1,040 | 1,533 | 3,575 |
| Net settled derivatives liabilities | 39,146 | 212 | 1,052 | 3,132 | 1,233 | 44,775 |
| Total derivative financial liabilities | 39,451 | 665 | 1,296 | 4,172 | 2,766 | 48,350 |

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £8,591 million at 31 December 2013 (2012: £9,520 million) with £4,233 million expiring within one year; £837 million between one and three years; £2,039 million between three and five years; and £1,482 million over five years (2012: £4,865 million expiring within one year; £1,302 million between one and three years; £1,729 million between three and five years; and £1,624 million over five years).

The majority of the Group's non-participating investment contract liabilities are unit-linked. These unit-linked products are invested in accordance with unit fund mandates. Clauses are included in policyholder contracts to permit the deferral of sales, where necessary, so that linked assets can be realised without being a forced seller.

The principal amount for undated subordinated liabilities with no redemption option is included within the over five years column; interest of approximately £85 million (2012: £79 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

Further information on the Group's liquidity exposures is provided on pages 109 to 115.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 54: FINANCIAL RISK MANAGEMENT** continued

Liabilities arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

| | Up to 1 month £m | 1-3 months £m | 3-12 months £m | 1-5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|---|
| At 31 December 2013 | 1,088 | 1,391 | 5,231 | 21,468 | 53,599 | 82,777 |
| At 31 December 2012 | 989 | 1,451 | 5,198 | 20,426 | 54,889 | 82,953 |

For insurance and participating investment contracts which are neither unit-linked nor in the Group's with-profit funds, in particular annuity liabilities, the aim is to invest in assets such that the cash flows on investments match those on the projected future liabilities.

The following tables set out the amounts and residual maturities of the Group's off balance sheet contingent liabilities and commitments.

| | **Up to 1 month £m** | **1-3 months £m** | **3-6 months £m** | **6-9 months £m** | **9-12 months £m** | **1-3 years £m** | **3-5 years £m** | **Over 5 years £m** | **Total £m** |
|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2013** | | | | | | | | | |
| Acceptances and endorsements | **59** | **56** | **9** | **–** | **10** | **15** | **13** | **42** | **204** |
| Other contingent liabilities | **256** | **501** | **207** | **145** | **464** | **377** | **118** | **608** | **2,676** |
| Total contingent liabilities | **315** | **557** | **216** | **145** | **474** | **392** | **131** | **650** | **2,880** |
| Lending commitments | **30,918** | **11,857** | **15,452** | **4,632** | **7,519** | **14,886** | **17,064** | **2,849** | **105,177** |
| Other commitments | **–** | **–** | **–** | **–** | **494** | **–** | **–** | **–** | **494** |
| Total commitments | **30,918** | **11,857** | **15,452** | **4,632** | **8,013** | **14,886** | **17,064** | **2,849** | **105,671** |
| **Total contingents and commitments** | **31,233** | **12,414** | **15,668** | **4,777** | **8,487** | **15,278** | **17,195** | **3,499** | **108,551** |
| | Up to 1 month £m | 1-3 months £m | 3-6 months £m | 6-9 months £m | 9-12 months £m | 1-3 years £m | 3-5 years £m | Over 5 years £m | Total £m |
| At 31 December 2012 | | | | | | | | | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Acceptances and endorsements | 48 | 8 | 17 | – | – | – | 33 | 1 | 107 |
| Other contingent liabilities | 375 | 409 | 254 | 113 | 85 | 662 | 144 | 747 | 2,789 |
| Total contingent liabilities | 423 | 417 | 271 | 113 | 85 | 662 | 177 | 748 | 2,896 |
| Lending commitments | 44,332 | 1,288 | 10,518 | 3,969 | 5,632 | 14,493 | 17,486 | 3,676 | 101,394 |
| Other commitments | – | – | 170 | 153 | 234 | – | – | – | 557 |
| Total commitments | 44,332 | 1,288 | 10,688 | 4,122 | 5,856 | 14,493 | 17,486 | 3,676 | 101,951 |
| Total contingents and commitments | 44,755 | 1,705 | 10,959 | 4,235 | 5,951 | 15,155 | 17,663 | 4,424 | 104,847 |

**CAPITAL RISK**

Capital risk is defined as the risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Capital risk appetite is set by the Board, reflecting the Group’s strategic plans, regulatory capital constraints and market expectations. It includes a number of minimum capital ratios in normal and stressed conditions as well as a specific measure for the Insurance business, set by the Insurance Board, taking account of the need to maintain regulatory solvency including appropriate management buffers. The Board and the Group Chief Executive, assisted by the Group Asset and Liability Committee and the Group Risk Committee, regularly review performance against the risk appetite. A key metric is the Group’s common equity tier 1 (CET1) capital ratio which the Group currently aims to maintain in excess of 10 per cent.

Additionally, a series of stress analyses is undertaken during the year to determine the adequacy of the Group’s capital resources in adverse economic scenarios including those provided by the PRA.

**INSURANCE RISK**

Insurance risk is the risk of reductions in earnings, capital 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.

The Group’s appetite for solvency and earnings in insurance entities is reviewed and approved annually by the Board. Insurance risks are measured using a variety of techniques including stress and scenario testing, and, where appropriate, stochastic modelling. Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations, as well as evaluating the effectiveness of controls put in place to manage insurance risk.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 55: CONSOLIDATED CASH FLOW STATEMENT

### (A) CHANGE IN OPERATING ASSETS

| | 2013<br>**£m** | 2012[1]<br>£m | 2011<br>£m |
|---|---|---|---|
| Change in loans and receivables | 28,041 | 50,773 | 39,361 |
| Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss | (6,476) | 524 | 5,867 |
| Change in other operating assets | (4,448) | (3,492) | (1,131) |
| Change in operating assets | 17,117 | 47,805 | 44,097 |

(B) CHANGE IN OPERATING LIABILITIES

| | 2013<br>**£m** | 2012[1]<br>£m | 2011<br>£m |
|---|---|---|---|
| Change in deposits from banks | (25,529) | (1,325) | (10,480) |
| Change in customer deposits | 16,747 | 13,392 | 20,283 |
| Change in debt securities in issue | (29,032) | (66,968) | (43,893) |
| Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss | (6,258) | 1,497 | 14,249 |
| Change in investment contract liabilities | 3,171 | 7,421 | 793 |
| Change in other operating liabilities | (3,369) | (170) | (139) |
| Change in operating liabilities | (44,270) | (46,153) | (19,187) |

[1] Restated – see note 1.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 55: CONSOLIDATED CASH FLOW STATEMENT** continued

**(C) NON-CASH AND OTHER ITEMS**

| | 2013 | 2012[1] | 2011[1] |
|---|---|---|---|
| | **£m** | £m | £m |
| Depreciation and amortisation | 1,940 | 2,126 | 2,175 |
| Impairment of tangible fixed assets | – | – | 65 |
| Revaluation of investment properties | (156) | 264 | 107 |
| Provision for impairment of disposal groups | 382 | 26 | – |
| Allowance for loan losses | 2,726 | 5,121 | 8,069 |
| Write-off of allowance for loan losses | (5,858) | (7,922) | (7,405) |
| Impairment of available-for-sale financial assets | 15 | 37 | 80 |
| Change in insurance contract liabilities | 5,300 | 3,929 | (2,081) |
| Payment protection insurance provision | 3,050 | 3,575 | – |
| Other regulatory provisions | 405 | 650 | 175 |
| Other provision movements | 2 | (101) | (294) |
| Net charge in respect of defined benefit schemes | 503 | 110 | 408 |
| Impact of consolidation and deconsolidation of OEICs[2] | 6,303 | (829) | (6,094) |
| Unwind of discount on impairment allowances | (351) | (374) | (226) |
| Foreign exchange impact on balance sheet[3] | 89 | (219) | 302 |
| Liability management losses (gains) within other income[4] | 80 | (59) | (599) |
| Interest expense on subordinated liabilities | 2,956 | 2,783 | 2,155 |
| (Profit) loss on disposal of businesses | (362) | 7 | 21 |
| Net gain on sale of available-for-sale financial assets | (629) | (3,547) | (343) |
| Hedging valuation adjustments on subordinated debt | (1,083) | 225 | 1,091 |
| Value of employee services | 434 | 337 | 363 |
| Issue of shares (non-cash) | 160 | 322 | 316 |
| Transactions in own shares | (480) | (407) | (276) |
| Accretion of discounts and amortisation of premiums and issue costs | 286 | 12 | 151 |
| Share of post-tax results of associates and joint ventures | (43) | (28) | (31) |
| Transfers to income statement from reserves | (550) | 198 | (85) |
| Profit on disposal of tangible fixed assets | (43) | (75) | (36) |
| Other non-cash items | (26) | (101) | 36 |
| Total non-cash items | 15,050 | 6,060 | (1,956) |
| Contributions to defined benefit schemes | (811) | (675) | (838) |
| Payments in respect of payment protection insurance provision | (2,674) | (3,299) | (1,045) |
| Payments in respect of other regulatory provisions | (360) | (20) | (497) |
| Other | 26 | 15 | 6 |
| Total other items | (3,819) | (3,979) | (2,374) |
| Non-cash and other items | 11,231 | 2,081 | (4,330) |

[1]Restated – see note 1.

2 These OEICs (Open-ended investment companies) are mutual funds which are consolidated if the Group manages the funds and also has a majority beneficial interest. The population of OEICs to be consolidated varies at each reporting date as external investors acquire and divest holdings in the various funds. The consolidation of these funds is effected by the inclusion of the fund investments and a matching liability to the unitholders; and changes in funds consolidated represent a non-cash movement on the balance sheet.

3 When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

4 A number of capital transactions entered into by the Group in 2011 and 2012 involved the exchange of existing securities for new issues and as a result there was no related cash flow.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 55: CONSOLIDATED CASH FLOW STATEMENT** continued

### (D) ANALYSIS OF CASH AND CASH EQUIVALENTS AS SHOWN IN THE BALANCE SHEET

| | **2013** | 2012[2] | 2011[2] |
|---|---|---|---|
| | **£m** | £m | £m |
| Cash and balances at central banks | **49,915** | 80,298 | 60,722 |
| Less: mandatory reserve deposits[1] | **(937 )** | (580 ) | (1,070 ) |
| | **48,978** | 79,718 | 59,652 |
| Loans and advances to banks | **25,365** | 32,757 | 32,877 |
| Less: amounts with a maturity of three months or more | **(7,546 )** | (11,417 ) | (6,640 ) |
| | **17,819** | 21,340 | 26,237 |
| Total cash and cash equivalents | **66,797** | 101,058 | 85,889 |

1 Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.
2 Restated - see note 1

Included within cash and cash equivalents at 31 December 2013 is £14,058 million (2012: £17,889 million; 2011: £21,601 million) held within the Group's life funds, which is not immediately available for use in the business.

### (E) ACQUISITION OF GROUP UNDERTAKINGS AND BUSINESSES

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| | £m | £m | £m |
| Net cash outflow arising from acquisitions of and additional investment in joint ventures in the year | (6 ) | (11 ) | (10 ) |
| Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000 | – | – | (3 ) |
| Net cash outflow | (6 ) | (11 ) | (13 ) |

### (F) DISPOSAL AND CLOSURE OF GROUP UNDERTAKINGS AND BUSINESSES

| | 2013 | 2012 | 2011 |
|---|---|---|---|

| | £m | £m | £m |
|---|---|---|---|
| Trading and other assets at fair value through profit or loss | 35,159 | – | 134 |
| Loans and advances to customers | 2,612 | 15 | 24 |
| Loans and advances to banks | 1,701 | 16 | – |
| Investment property | 582 | – | – |
| Value of in-force business | 831 | – | – |
| Other intangible assets | 251 | – | – |
| Tangible fixed assets | 67 | – | 147 |
| | 41,203 | 31 | 305 |
| Customer deposits | (1,923) | – | – |
| Debt securities in issue | (264) | – | – |
| Liabilities arising from insurance contracts and participating investment contracts | (451) | – | – |
| Liabilities arising from non-participating investment contracts | (29,953) | – | – |
| Non-controlling interests | (357) | (38) | (197) |
| Other net assets (liabilities) | (6,160) | 51 | 211 |
| | (39,108) | 13 | 14 |
| Net assets | 2,095 | 44 | 319 |
| Cash and cash equivalents disposed | (1,702) | – | – |
| Non-cash consideration received | (59) | – | – |
| Profit (loss) on sale | 362 | (7) | (21) |
| Net cash inflow (outflow) | 696 | 37 | 298 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION**

As explained in note 1, the Group has adopted IFRS 10 *Consolidated Financial Statements* and Amendments to IAS 19 *Employee Benefits* (IAS 19R) on 1 January 2013.

The Group has restated information for the preceding comparative periods.

The following tables summarise the adjustments arising on the adoption of IAS 19R and IFRS 10 to the Group's:

– income statements, statements of comprehensive income and statements of cash flows for the year ended 31 December 2012 and the year ended 31 December 2011; and

– balance sheets at 31 December 2012, 31 December 2011 and 1 January 2011.

**CONSOLIDATED INCOME STATEMENT – YEAR ENDED 31 DECEMBER 2012**

| | As previously reported | IFRS 10 | IAS 19 Revised | Restated |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Interest and similar income | 23,535 | 13 | – | 23,548 |
| Interest and similar expense | (14,460) | (1,370) | – | (15,830) |
| Net interest income | 9,075 | (1,357) | – | 7,718 |
| Fee and commission income | 4,731 | (81) | – | 4,650 |
| Fee and commission expense | (1,438) | (6) | – | (1,444) |
| Net fee and commission income | 3,293 | (87) | – | 3,206 |
| Net trading income | 13,554 | 1,451 | – | 15,005 |
| Insurance premium income | 8,284 | – | – | 8,284 |
| Other operating income | 4,700 | – | – | 4,700 |
| Other income | 29,831 | 1,364 | – | 31,195 |
| Total income | 38,906 | 7 | – | 38,913 |
| Insurance claims | (18,396) | – | – | (18,396) |
| Total income, net of insurance claims | 20,510 | 7 | – | 20,517 |
| Regulatory provisions | (4,175) | – | – | (4,175) |
| Other operating expenses | (11,756) | (1) | (42) | (11,799) |

| | | | | |
|---|---|---|---|---|
| Total operating expenses | (15,931 ) | (1 ) | (42 ) | (15,974 ) |
| Trading surplus | 4,579 | 6 | (42 ) | 4,543 |
| Impairment | (5,149 ) | – | – | (5,149 ) |
| (Loss) profit before tax | (570 ) | 6 | (42 ) | (606 ) |
| Taxation | (773 ) | (6 ) | (2 ) | (781 ) |
| Loss for the year | (1,343 ) | – | (44 ) | (1,387 ) |
| Profit attributable to non-controlling interests | 84 | – | – | 84 |
| Loss attributable to equity shareholders | (1,427 ) | – | (44 ) | (1,471 ) |
| Loss for the year | (1,343 ) | – | (44 ) | (1,387 ) |
| Basic loss per share | (2.0)p | | | (2.1)p |
| Diluted loss per share | (2.0)p | | | (2.1)p |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME – YEAR ENDED 31 DECEMBER 2012**

| | As previously reported | IFRS 10 | IAS 19 Revised | Restated |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Loss for the year | (1,343) | – | (44) | (1,387) |
| Other comprehensive income | | | | |
| Items that will not subsequently be reclassified to profit or loss: | | | | |
| Post-retirement defined benefit scheme remeasurements: | | | | |
| Remeasurements before taxation | – | – | (2,136) | (2,136) |
| Taxation | – | – | 491 | 491 |
| | – | – | (1,645) | (1,645) |
| Items that may subsequently be reclassified to profit or loss: | | | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets: | | | | |
| Adjustments on transfers from held-to-maturity portfolio | 1,168 | – | – | 1,168 |
| Change in fair value | 900 | – | – | 900 |
| Income statement transfers in respect of disposals | (3,547) | – | – | (3,547) |
| Income statement transfers in respect of impairment | 42 | – | – | 42 |
| Other income statement transfers | 169 | – | – | 169 |
| Taxation | 339 | – | – | 339 |
| | (929) | – | – | (929) |
| Movements in cash flow hedging reserve: | | | | |
| Effective portion of changes in fair value | 116 | – | – | 116 |
| Net income statement transfers | (92) | – | – | (92) |
| Taxation | 1 | – | – | 1 |
| | 25 | – | – | 25 |
| Currency translation differences (tax: nil) | (14) | – | – | (14) |
| Other comprehensive income for the year, net of tax | (918) | – | (1,645) | (2,563) |
| Total comprehensive income for the year | (2,261) | – | (1,689) | (3,950) |
| Total comprehensive income attributable to non-controlling interests | 82 | – | – | 82 |
| Total comprehensive income attributable to equity shareholders | (2,343) | – | (1,689) | (4,032) |
| Total comprehensive income for the year | (2,261) | – | (1,689) | (3,950) |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED CASH FLOW STATEMENT – YEAR ENDED 31 DECEMBER 2012**

| | As previously reported | IFRS 10 | IAS 19 Revised | Restated |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| (Loss) profit before tax | (570) | 6 | (42) | (606) |
| Adjustments for: | | | | |
| Change in operating assets | 48,333 | (528) | – | 47,805 |
| Change in operating liabilities | (46,681) | 528 | – | (46,153) |
| Non-cash and other items | 2,045 | (6) | 42 | 2,081 |
| Tax paid | (78) | – | – | (78) |
| Net cash provided by operating activities | 3,049 | – | – | 3,049 |
| | | | | |
| Cash flows from investing activities | | | | |
| Purchase of financial assets | (22,050) | – | – | (22,050) |
| Proceeds from sale and maturity of financial assets | 37,664 | – | – | 37,664 |
| Purchase of fixed assets | (3,003) | – | – | (3,003) |
| Proceeds from sale of fixed assets | 2,595 | – | – | 2,595 |
| Acquisition of businesses, net of cash acquired | (11) | – | – | (11) |
| Disposal of businesses, net of cash disposed | 37 | – | – | 37 |
| Net cash provided by investing activities | 15,232 | – | – | 15,232 |
| | | | | |
| Cash flows from financing activities | | | | |
| Dividends paid to non-controlling interests | (56) | – | – | (56) |
| Interest paid on subordinated liabilities | (2,577) | – | – | (2,577) |
| Proceeds from issue of ordinary shares | 170 | – | – | 170 |
| Repayment of subordinated liabilities | (664) | – | – | (664) |
| Change in non-controlling interests | 23 | – | – | 23 |
| Net cash used in financing activities | (3,104) | – | – | (3,104) |
| Effects of exchange rate changes on cash and cash equivalents | (8) | – | – | (8) |
| Change in cash and cash equivalents | 15,169 | – | – | 15,169 |
| Cash and cash equivalents at beginning of year | 85,889 | – | – | 85,889 |
| Cash and cash equivalents at end of year | 101,058 | – | – | 101,058 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED BALANCE SHEET AT 31 DECEMBER 2012**

| | As previously reported | IFRS 10 | IAS 19 Revised | Restated |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Assets | | | | |
| Cash and balances at central banks | 80,298 | – | – | 80,298 |
| Items in course of collection from banks | 1,256 | – | – | 1,256 |
| Trading and other financial assets at fair value through profit or loss | 153,990 | 6,630 | – | 160,620 |
| Derivative financial instruments | 56,550 | 7 | – | 56,557 |
| Loans and receivables: | | | | |
| Loans and advances to banks | 29,417 | 3,340 | – | 32,757 |
| Loans and advances to customers | 517,225 | – | – | 517,225 |
| Debt securities | 5,273 | – | – | 5,273 |
| | 551,915 | 3,340 | – | 555,255 |
| Available-for-sale financial assets | 31,374 | – | – | 31,374 |
| Investment properties | 5,405 | – | – | 5,405 |
| Goodwill | 2,016 | – | – | 2,016 |
| Value of in-force business | 6,800 | – | – | 6,800 |
| Other intangible assets | 2,792 | – | – | 2,792 |
| Tangible fixed assets | 7,342 | – | – | 7,342 |
| Current tax recoverable | 354 | – | – | 354 |
| Deferred tax assets | 4,285 | – | 628 | 4,913 |
| Retirement benefit assets | 1,867 | – | (1,126) | 741 |
| Other assets | 18,308 | 190 | – | 18,498 |
| Total assets | 924,552 | 10,167 | (498) | 934,221 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED BALANCE SHEET AT 31 DECEMBER 2012** continued

| | As previously reported | IFRS 10 | IAS 19 Revised | Restated |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Equity and liabilities | | | | |
| Liabilities | | | | |
| Deposits from banks | 38,405 | – | – | 38,405 |
| Customer deposits | 426,912 | – | – | 426,912 |
| Items in course of transmission to banks | 996 | – | – | 996 |
| Trading and other financial liabilities at fair value through profit or loss | 35,972 | (2,580 ) | – | 33,392 |
| Derivative financial instruments | 48,665 | 11 | – | 48,676 |
| Notes in circulation | 1,198 | – | – | 1,198 |
| Debt securities in issue | 117,369 | (116 ) | – | 117,253 |
| Liabilities arising from insurance contracts and participating investment contracts | 82,953 | – | – | 82,953 |
| Liabilities arising from non-participating investment contracts | 54,372 | – | – | 54,372 |
| Unallocated surplus within insurance businesses | 267 | – | – | 267 |
| Other liabilities | 33,941 | 12,852 | – | 46,793 |
| Retirement benefit obligations | 300 | – | 1,605 | 1,905 |
| Current tax liabilities | 138 | – | – | 138 |
| Deferred tax liabilities | 327 | – | – | 327 |
| Other provisions | 3,961 | – | – | 3,961 |
| Subordinated liabilities | 34,092 | – | – | 34,092 |
| Total liabilities | 879,868 | 10,167 | 1,605 | 891,640 |
| Equity | | | | |
| Share capital | 7,042 | – | – | 7,042 |
| Share premium account | 16,872 | – | – | 16,872 |
| Other reserves | 12,902 | – | – | 12,902 |
| Retained profits | 7,183 | – | (2,103 ) | 5,080 |
| Shareholders' equity | 43,999 | – | (2,103 ) | 41,896 |
| Non-controlling interests | 685 | – | – | 685 |
| Total equity | 44,684 | – | (2,103 ) | 42,581 |
| Total equity and liabilities | 924,552 | 10,167 | (498 ) | 934,221 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED INCOME STATEMENT – YEAR ENDED 31 DECEMBER 2011**

| | As previously reported £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|
| Interest and similar income | 26,316 | – | 26,316 |
| Interest and similar expense | (13,618) | – | (13,618) |
| Net interest income | 12,698 | – | 12,698 |
| Fee and commission income | 4,935 | – | 4,935 |
| Fee and commission expense | (1,391) | – | (1,391) |
| Net fee and commission income | 3,544 | – | 3,544 |
| Net trading income | (368) | – | (368) |
| Insurance premium income | 8,170 | – | 8,170 |
| Other operating income | 2,799 | – | 2,799 |
| Other income | 14,145 | – | 14,145 |
| Total income | 26,843 | – | 26,843 |
| Insurance claims | (6,041) | – | (6,041) |
| Total income, net of insurance claims | 20,802 | – | 20,802 |
| Regulatory provisions | (175) | – | (175) |
| Other operating expenses | (12,875) | (209) | (13,084) |
| Total operating expenses | (13,050) | (209) | (13,259) |
| Trading surplus | 7,752 | (209) | 7,543 |
| Impairment | (8,094) | – | (8,094) |
| Profit (loss) before tax | (342) | (209) | (551) |
| Taxation | (36) | 33 | (3) |
| Profit (loss) for the year | (378) | (176) | (554) |
| Profit attributable to non-controlling interests | 73 | – | 73 |
| Profit (loss) attributable to equity shareholders | (451) | (176) | (627) |
| Profit (loss) for the year | (378) | (176) | (554) |
| Basic loss per share | (0.7)p | | (0.9)p |
| Diluted loss per share | (0.7)p | | (0.9)p |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME – YEAR ENDED 31 DECEMBER 2011**

| | As previously reported £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|
| Loss for the year | (378) | (176) | (554) |
| Other comprehensive income | | | |
| Items that will not subsequently be reclassified to profit or loss: | | | |
| Post-retirement defined benefit scheme remeasurements | | | |
| Remeasurement before taxation | – | 624 | 624 |
| Taxation | – | (155) | (155) |
| | – | 469 | 469 |
| Items that may subsequently be reclassified to profit or loss: | | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets: | | | |
| Change in fair value | 2,527 | – | 2,527 |
| Income statement transfers in respect of disposals | (343) | – | (343) |
| Income statement transfers in respect of impairment | 80 | – | 80 |
| Other income statement transfers | (79) | – | (79) |
| Taxation | (575) | – | (575) |
| | 1,610 | – | 1,610 |
| Movements in cash flow hedging reserve: | | | |
| Effective portion of changes in fair value | 916 | – | 916 |
| Net income statement transfers | 70 | – | 70 |
| Taxation | (270) | – | (270) |
| | 716 | – | 716 |
| Currency translation differences (tax: nil) | (84) | – | (84) |
| Other comprehensive income for the year, net of tax | 2,242 | 469 | 2,711 |
| Total comprehensive income for the year | 1,864 | 293 | 2,157 |
| Total comprehensive income attributable to non-controlling interests | 72 | – | 72 |
| Total comprehensive income attributable to equity shareholders | 1,792 | 293 | 2,085 |
| Total comprehensive income for the year | 1,864 | 293 | 2,157 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED CASH FLOW STATEMENT – YEAR ENDED 31 DECEMBER 2011**

| | As previously reported £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|
| Profit (loss) before tax | (342) | (209) | (551) |
| Adjustments for: | | | |
| Change in operating assets | 44,097 | – | 44,097 |
| Change in operating liabilities | (19,187) | – | (19,187) |
| Non-cash and other items | (4,539) | 209 | (4,330) |
| Tax paid | (136) | – | (136) |
| Net cash provided by operating activities | 19,893 | – | 19,893 |
| | | | |
| Cash flows from investing activities | | | |
| Purchase of financial assets | (28,995) | – | (28,995) |
| Proceeds from sale and maturity of financial assets | 36,523 | – | 36,523 |
| Purchase of fixed assets | (3,095) | – | (3,095) |
| Proceeds from sale of fixed assets | 2,214 | – | 2,214 |
| Acquisition of businesses, net of cash acquired | (13) | – | (13) |
| Disposal of businesses, net of cash disposed | 298 | – | 298 |
| Net cash provided by (used in) investing activities | 6,932 | – | 6,932 |
| | | | |
| Cash flows from financing activities | | | |
| Dividends paid to non-controlling interests | (50) | – | (50) |
| Interest paid on subordinated liabilities | (2,126) | – | (2,126) |
| Proceeds from issue of ordinary shares | – | – | – |
| Repayment of subordinated liabilities | (1,074) | – | (1,074) |
| Change in non-controlling interests | 8 | – | 8 |
| Net cash used in financing activities | (3,242) | – | (3,242) |
| Effects of exchange rate changes on cash and cash equivalents | 6 | – | 6 |
| Change in cash and cash equivalents | 23,589 | – | 23,589 |
| Cash and cash equivalents at beginning of year | 62,300 | – | 62,300 |
| Cash and cash equivalents at end of year | 85,889 | – | 85,889 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED BALANCE SHEET AT 1 JANUARY 2012**

| | As previously reported £m | IFRS 10 £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|---|
| Assets | | | | |
| Cash and balances at central banks | 60,722 | – | – | 60,722 |
| Items in course of collection from banks | 1,408 | – | – | 1,408 |
| Trading and other financial assets at fair value through profit or loss | 139,510 | 9,104 | – | 148,614 |
| Derivative financial instruments | 66,013 | 60 | – | 66,073 |
| Loans and receivables: | | | | |
| Loans and advances to banks | 32,606 | 271 | – | 32,877 |
| Loans and advances to customers | 565,638 | – | – | 565,638 |
| Debt securities | 12,470 | – | – | 12,470 |
| | 610,714 | 271 | – | 610,985 |
| Available-for-sale financial assets | 37,406 | – | – | 37,406 |
| Held-to-maturity investments | 8,098 | – | – | 8,098 |
| Investment properties | 6,122 | – | – | 6,122 |
| Goodwill | 2,016 | – | – | 2,016 |
| Value of in-force business | 6,638 | – | – | 6,638 |
| Other intangible assets | 3,196 | – | – | 3,196 |
| Tangible fixed assets | 7,673 | – | – | 7,673 |
| Current tax recoverable | 434 | – | – | 434 |
| Deferred tax assets | 4,496 | – | 139 | 4,635 |
| Retirement benefit assets | 1,338 | – | (76) | 1,262 |
| Other assets | 14,762 | 204 | – | 14,966 |
| Total assets | 970,546 | 9,639 | 63 | 980,248 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED BALANCE SHEET AT 1 JANUARY 2012** continued

| | As previously reported £m | IFRS 10 £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|---|
| Equity and liabilities | | | | |
| Liabilities | | | | |
| Deposits from banks | 39,810 | – | – | 39,810 |
| Customer deposits | 413,906 | – | – | 413,906 |
| Items in course of transmission to banks | 844 | – | – | 844 |
| Trading and other financial liabilities at fair value through profit or loss | 24,955 | (2,598) | – | 22,357 |
| Derivative financial instruments | 58,212 | 53 | – | 58,265 |
| Notes in circulation | 1,145 | – | – | 1,145 |
| Debt securities in issue | 185,059 | (95) | – | 184,964 |
| Liabilities arising from insurance contracts and participating investment contracts | 78,991 | – | – | 78,991 |
| Liabilities arising from non-participating investment contracts | 49,636 | – | – | 49,636 |
| Unallocated surplus within insurance businesses | 300 | – | – | 300 |
| Other liabilities | 32,041 | 12,279 | – | 44,320 |
| Retirement benefit obligations | 381 | – | 477 | 858 |
| Current tax liabilities | 103 | – | – | 103 |
| Deferred tax liabilities | 314 | – | – | 314 |
| Other provisions | 3,166 | – | – | 3,166 |
| Subordinated liabilities | 35,089 | – | – | 35,089 |
| Total liabilities | 923,952 | 9,639 | 477 | 934,068 |
| Equity | | | | |
| Share capital | 6,881 | – | – | 6,881 |
| Share premium account | 16,541 | – | – | 16,541 |
| Other reserves | 13,818 | – | – | 13,818 |
| Retained profits | 8,680 | – | (414) | 8,266 |
| Shareholders' equity | 45,920 | – | (414) | 45,506 |
| Non-controlling interests | 674 | – | – | 674 |
| Total equity | 46,594 | – | (414) | 46,180 |
| Total equity and liabilities | 970,546 | 9,639 | 63 | 980,248 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED BALANCE SHEET AT 1 JANUARY 2011**

| | As previously reported £m | IFRS 10 £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|---|
| Assets | | | | |
| Cash and balances at central banks | 38,115 | – | – | 38,115 |
| Items in course of collection from banks | 1,368 | – | – | 1,368 |
| Trading and other financial assets at fair value through profit or loss | 156,191 | – | – | 156,191 |
| Derivative financial instruments | 50,777 | – | – | 50,777 |
| Loans and receivables: | | – | – | |
| Loans and advances to banks | 30,272 | – | – | 30,272 |
| Loans and advances to customers | 592,597 | – | – | 592,597 |
| Debt securities | 25,735 | – | – | 25,735 |
| | 648,604 | – | – | 648,604 |
| Available-for-sale financial assets | 42,955 | – | – | 42,955 |
| Held-to-maturity investments | 7,905 | – | – | 7,905 |
| Investment properties | 5,997 | – | – | 5,997 |
| Goodwill | 2,016 | – | – | 2,016 |
| Value of in-force business | 7,367 | – | – | 7,367 |
| Other intangible assets | 3,496 | – | – | 3,496 |
| Tangible fixed assets | 8,190 | – | – | 8,190 |
| Current tax recoverable | 621 | – | – | 621 |
| Deferred tax assets | 5,028 | – | 261 | 5,289 |
| Retirement benefit assets | 736 | – | (430) | 306 |
| Other assets | 13,072 | – | – | 13,072 |
| Total assets | 992,438 | – | (169) | 992,269 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 56: RESTATEMENT OF PRIOR PERIOD INFORMATION** continued

**CONSOLIDATED BALANCE SHEET AT 1 JANUARY 2011** continued

| | As previously reported £m | IFRS 10 £m | IAS 19 Revised £m | Restated £m |
|---|---|---|---|---|
| Equity and liabilities | | | | |
| Liabilities | | | | |
| Deposits from banks | 50,363 | – | – | 50,363 |
| Customer deposits | 393,633 | – | – | 393,633 |
| Items in course of transmission to banks | 802 | – | – | 802 |
| Trading and other financial liabilities at fair value through profit or loss | 26,762 | – | – | 26,762 |
| Derivative financial instruments | 42,158 | – | – | 42,158 |
| Notes in circulation | 1,074 | – | – | 1,074 |
| Debt securities in issue | 228,866 | – | – | 228,866 |
| Liabilities arising from insurance contracts and participating investment contracts | 80,729 | – | – | 80,729 |
| Liabilities arising from non-participating investment contracts | 51,363 | – | – | 51,363 |
| Unallocated surplus within insurance businesses | 643 | – | – | 643 |
| Other liabilities | 29,696 | – | – | 29,696 |
| Retirement benefit obligations | 423 | – | 538 | 961 |
| Current tax liabilities | 149 | – | – | 149 |
| Deferred tax liabilities | 247 | – | – | 247 |
| Other provisions | 1,532 | – | – | 1,532 |
| Subordinated liabilities | 36,232 | – | – | 36,232 |
| Total liabilities | 944,672 | – | 538 | 945,210 |
| | | | | |
| Equity | | | | |
| Share capital | 6,815 | – | – | 6,815 |
| Share premium account | 16,291 | – | – | 16,291 |
| Other reserves | 11,575 | – | – | 11,575 |
| Retained profits | 9,044 | – | (707) | 8,337 |
| Shareholders' equity | 43,725 | – | (707) | 43,018 |
| Non-controlling interests | 841 | – | – | 841 |
| Total equity | 44,566 | – | (707) | 43,859 |
| Total equity and liabilities | 992,438 | – | (169) | 992,269 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 57: FUTURE ACCOUNTING DEVELOPMENTS**

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2013 and have not been applied in preparing these financial statements. Save as disclosed below, the full impact of these accounting changes is being assessed by the Group.

| **Pronouncement** | **Nature of change** | **IASB effective date** |
|---|---|---|
| Amendment to IAS 32 *Financial Instruments: Presentation – 'Offsetting Financial Assets and Financial Liabilities'* | Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard. Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement. This amendment is not expected to have a significant impact on the Group. | Annual periods beginning on or after 1 January 2014. |
| Amendments to IAS 39 *Financial Instruments: Recognition and Measurement – 'Novation of Derivatives and Continuation of Hedge Accounting'* | Provides relief from discontinuing hedge accounting in circumstances where a derivative designated as a hedging instrument is novated to a central counterparty as a consequence or introduction of laws or regulations. These amendments are not expected to have a significant impact on the Group. | Annual periods beginning on or after 1 January 2014. |
| IFRIC 21 *Levies*[1] | Clarifies that the obligating event that gives rise to a liability to pay a government levy is the activity that triggers the payment of the levy as set out in the relevant legislation. An entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period. This interpretation is not expected to have a significant impact on the Group. | Annual periods beginning on or after 1 January 2014. |
| IFRS 9 *Financial Instruments*[1,2] | Replaces those parts of IAS 39 *Financial Instruments: Recognition and Measurement* relating to the classification, measurement and derecognition of financial assets and liabilities. IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to the entity's own credit risk is recorded in other comprehensive income. The hedge accounting requirements are more closely aligned with risk management practices and follow a more principle-based approach. | Date yet to be determined. |

[1] As at 5 March 2014, these pronouncements are awaiting EU endorsement.

2 IFRS 9 is the standard which will replace IAS 39. Further changes to IFRS 9 are expected dealing with impairment of financial assets measured at amortised cost, which will be based on expected rather than incurred credit losses, and limited amendments to classification and measurement which include the introduction of a third measurement category, fair value through other comprehensive income. Until the standard is complete, it is not possible to determine the overall impact of the standard on the financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 58: PARENT COMPANY DISCLOSURES**

**A COMPANY INCOME STATEMENT**

| | 2013 £ million | 2012 £ million | 2011 £ million |
|---|---|---|---|
| Net interest income (expense) | 166 | (134) | (19) |
| Other income | (1,009) | 82 | 45 |
| Total income | (843) | (52) | 26 |
| Operating expenses | (248) | (207) | (228) |
| Loss on ordinary activities before tax | (1,091) | (259) | (202) |
| Taxation credit | 245 | 35 | 34 |
| Loss for the year | (846) | (224) | (168) |

B COMPANY BALANCE SHEET

| | **2013 £ million** | 2012 £ million |
|---|---|---|
| Assets | | |
| Non-current assets: | | |
| Investment in subsidiaries | 40,933 | 40,534 |
| Loans to subsidiaries | 11,043 | 8,123 |
| Deferred tax assets | 4 | 9 |
| | 51,980 | 48,666 |
| Current assets: | | |
| Derivative financial instruments | 1,452 | 1,693 |
| Other assets | 1,171 | 974 |
| Amounts due from subsidiaries | 67 | 147 |
| Cash and cash equivalents | 511 | 2,231 |
| Current tax recoverable | 19 | – |
| | 3,220 | 5,045 |
| Total assets | 55,200 | 53,711 |
| Equity and liabilities | | |
| Capital and reserves: | | |
| Share capital | 7,145 | 7,042 |
| Share premium account | 17,279 | 16,872 |
| Merger reserve | 7,764 | 7,764 |
| Capital redemption reserve | 4,115 | 4,115 |
| Retained profits | 1,414 | 2,017 |
| Total equity | 37,717 | 37,810 |
| Non-current liabilities: | | |
| Debt securities in issue | 535 | 545 |

| | | |
|---|---|---|
| Subordinated liabilities | 1,669 | 4,349 |
| | 2,204 | 4,894 |
| Current liabilities: | | |
| Current tax liabilities | – | 266 |
| Other liabilities | 15,279 | 10,741 |
| | 15,279 | 11,007 |
| Total liabilities | 17,483 | 15,901 |
| Total equity and liabilities | 55,200 | 53,711 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 58: PARENT COMPANY DISCLOSURES** continued

**C COMPANY STATEMENT OF CHANGES IN EQUITY**

| | **Share capital and premium £ million** | **Merger reserve £ million** | Capital redemption reserve £ million | **Retained profits £ million** | **Total £ million** |
|---|---|---|---|---|---|
| Balance at 31 December 2010 | 23,106 | 7,764 | 4,115 | 2,276 | 37,261 |
| Total comprehensive income[1] | – | – | – | (168) | (168) |
| Issue of ordinary shares | 316 | – | – | – | 316 |
| Movement in treasury shares | – | – | – | (291) | (291) |
| Value of employee services: | | | | | |
| Share option schemes | – | – | – | 143 | 143 |
| Other employee award schemes | – | – | – | 238 | 238 |
| Balance at 31 December 2011 | 23,422 | 7,764 | 4,115 | 2,198 | 37,499 |
| Total comprehensive income[1] | – | – | – | (224) | (224) |
| Issue of ordinary shares | 492 | – | – | – | 492 |
| Movement in treasury shares | – | – | – | (282) | (282) |
| Value of employee services: | | | | | |
| Share option schemes | – | – | – | 69 | 69 |
| Other employee award schemes | – | – | – | 256 | 256 |
| Balance at 31 December 2012 | 23,914 | 7,764 | 4,115 | 2,017 | 37,810 |
| **Total comprehensive income[1]** | – | – | – | (846) | (846) |
| Issue of ordinary shares | 510 | – | – | – | 510 |
| Movement in treasury shares | – | – | – | (165) | (165) |
| Value of employee services: | | | | | |
| Share option schemes | – | – | – | 116 | 116 |
| Other employee award schemes | – | – | – | 292 | 292 |
| Balance at 31 December 2013 | 24,424 | 7,764 | 4,115 | 1,414 | 37,717 |

[1] Total comprehensive income comprises only the loss for the year.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 58: PARENT COMPANY DISCLOSURES** continued

**D COMPANY CASH FLOW STATEMENT**

| | **2013 £ million** | 2012 £ million | 2011 £ million |
|---|---|---|---|
| Loss before tax | **(1,090 )** | (259 ) | (202 ) |
| Fair value and exchange adjustments and other non-cash items | **137** | 245 | 329 |
| Change in other assets | **124** | 14 | 255 |
| Change in other liabilities and other items | **4,699** | 750 | 2,576 |
| Tax received (paid) | **(35 )** | 290 | 151 |
| Net cash provided by (used in) operating activities | **3,835** | 1,040 | 3,109 |
| Cash flows from investing activities | | | |
| Capital injection into Lloyds Bank plc | **—** | – | (2,340 ) |
| Amounts advanced to subsidiaries | **(3,082 )** | – | – |
| Redemption of loans to subsidiaries | **197** | 209 | – |
| Net cash used in investing activities | **(2,885 )** | 209 | (2,340 ) |
| Cash flows from financing activities | | | |
| Interest paid on subordinated liabilities | **(253 )** | (293 ) | (39 ) |
| Repayment of subordinated liabilities | **(2,767 )** | – | – |
| Proceeds from issue of ordinary shares | **350** | 170 | – |
| Net cash provided by financing activities | **(2,670 )** | (123 ) | (39 ) |
| Change in cash and cash equivalents | **(1,720 )** | 1,126 | 730 |
| Cash and cash equivalents at beginning of year | **2,231** | 1,105 | 375 |
| Cash and cash equivalents at end of year | **511** | 2,231 | 1,105 |

**E INTERESTS IN SUBSIDIARIES**

The principal subsidiaries, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of Lloyds Banking Group plc, are:

| | Country of registration/ Incorporation | Percentage of equity share capital and voting rights held | Nature of business |
|---|---|---|---|
| Lloyds Bank plc (previously Lloyds TSB Bank plc) | England | 100% | Banking and financial services |

| | | | |
|---|---|---|---|
| Scottish Widows plc | Scotland | 100%[1] | Life assurance |
| HBOS plc | Scotland | 100%[1] | Holding company |
| Bank of Scotland plc | Scotland | 100%[1] | Banking and financial services |
| St. Andrew’s Insurance plc | England | 100%[1] | General insurance |
| Clerical Medical Investment Group Limited | England | 100%[1] | Life assurance |
| Clerical Medical Managed Funds Limited | England | 100%[1] | Life assurance |
| TSB Bank plc (previously Lloyds TSB Scotland plc) | Scotland | 100%[1] | Banking and financial services |

[1] Indirect interest.

The principal area of operation for each of the above subsidiaries is the United Kingdom.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION**

The Company owns 100 per cent of the share capital of Lloyds Bank plc (Lloyds Bank), which intends to offer and sell certain securities in the US from time to time utilising a registration statement on Form F-3 filed with the SEC by the Company. This will be accompanied by a full and unconditional guarantee by the Company.

Lloyds Bank intends to utilise an exception provided in Rule 3-10 of Regulation S-X, which allows it to not file its financial statements with the SEC. In accordance with the requirements to qualify for the exception, presented below is condensed consolidating financial information for:

–The Company on a stand-alone basis as guarantor;

–Lloyds Bank on a stand-alone basis as issuer;

–Non-guarantor subsidiaries of the Company and Lloyds Bank on a combined basis (Subsidiaries);

–Consolidation adjustments; and

–Lloyds Banking Group's consolidated amounts (the Group).

Under IAS 27, the Company and Lloyds Bank account for investments in their subsidiary undertakings at cost less impairment. Rule 3-10 of Regulation S-X requires a company to account for its investments in subsidiary undertakings using the equity method, which would increase/ (decrease) the results of the Company and Lloyds Bank in the information below by £8 million and £(3,174) million, respectively, for the year ended 31 December 2013; by £(1,247) million and £872 million, respectively, for the year ended 31 December 2012; and by £(459) million and £(1,331) million, respectively, for the year ended 31 December 2011. The net assets of the Company and Lloyds Bank in the information below would also be increased by £1,272 million and £2,458 million, respectively, at 31 December 2013; and by £4,086 million and £7,133 million, respectively, at 31 December 2012.

**INCOME STATEMENTS**

| **For the year ended 31 December 2013** | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| Net interest income | 166 | 2,645 | 5,278 | (751) | 7,338 |
| Other income | (1,009) | 9,425 | 29,711 | (7,480) | 30,647 |

| | | | | | |
|---|---|---|---|---|---|
| Total income | (843) | 12,070 | 34,989 | (8,231) | 37,985 |
| Insurance claims | – | – | (19,507) | – | (19,507) |
| Total income, net of insurance claims | (843) | 12,070 | 15,482 | (8,231) | 18,478 |
| Operating expenses | (248) | (8,907) | (6,870) | 703 | (15,322) |
| Trading surplus (deficit) | (1,091) | 3,163 | 8,612 | (7,528) | 3,156 |
| Impairment | – | (649) | (2,636) | 544 | (2,741) |
| Profit (loss) before tax | (1,091) | 2,514 | 5,976 | (6,984) | 415 |
| Taxation | 245 | 258 | (1,648) | (72) | (1,217) |
| **Profit (loss) for the year** | (846) | 2,772 | 4,328 | (7,056) | (802) |

| For the year ended 31 December 2012[1] | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| Net interest income | (134) | 2,351 | 6,239 | (738) | 7,718 |
| Other income | 82 | 5,541 | 27,641 | (2,069) | 31,195 |
| Total income | (52) | 7,892 | 33,880 | (2,807) | 38,913 |
| Insurance claims | – | – | (18,400) | 4 | (18,396) |
| Total income, net of insurance claims | (52) | 7,892 | 15,480 | (2,803) | 20,517 |
| Operating expenses | (207) | (9,040) | (7,249) | 522 | (15,974) |
| Trading surplus (deficit) | (259) | (1,148) | 8,231 | (2,281) | 4,543 |
| Impairment | – | (1,583) | (4,526) | 960 | (5,149) |
| Profit (loss) before tax | (259) | (2,731) | 3,705 | (1,321) | (606) |
| Taxation | 35 | 544 | (1,330) | (30) | (781) |
| **Profit (loss) for the year** | (224) | (2,187) | 2,375 | (1,351) | (1,387) |

[1]Restated – see note 1 on page F-11.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| For the year ended 31 December 2011[1] | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| Net interest income | (19) | 3,366 | 10,025 | (674) | 12,698 |
| Other income | 45 | 7,989 | 8,836 | (2,725) | 14,145 |
| Total income | 26 | 11,355 | 18,861 | (3,399) | 26,843 |
| Insurance claims | – | – | (6,041) | – | (6,041) |
| Total income, net of insurance claims | 26 | 11,355 | 12,820 | (3,399) | 20,802 |
| Operating expenses | (228) | (6,434) | (6,858) | 261 | (13,259) |
| Trading (deficit) surplus | (202) | 4,921 | 5,962 | (3,138) | 7,543 |
| Impairment | – | (2,770) | (7,440) | 2,116 | (8,094) |
| Loss on disposal of businesses | – | – | (135) | 135 | – |
| (Loss) profit before tax | (202) | 2,151 | 1,613 | (887) | (551) |
| Taxation | 34 | 472 | (374) | (135) | (3) |
| (Loss) profit for the year | (168) | 2,623 | (1,987) | (1,022) | (554) |

[1] Restated – see note 1 on page F-11.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| For the year ended 31 December 2013 | **Company £m** | **Lloyds Bank £m** | **Subsidiaries £m** | **Consolidation adjustments £m** | **Group £m** |
|---|---|---|---|---|---|
| Loss for the year | (845) | 2,772 | 4,328 | (7,057) | (802) |
| Other comprehensive income | | | | | |
| Items that will not subsequently be reclassified to profit or loss: | | | | | |
| Post–retirement defined benefit scheme remeasurements: | | | | | |
| Remeasurements before taxation | – | 400 | (536) | – | (136) |
| Taxation | – | (80) | 108 | – | 28 |
| | – | 320 | (428) | – | (108) |
| Items that may subsequently be reclassified to profit or loss: | | | | | |
| Movements in revaluation reserve in respect of available–for– sale financial assets: | | | | | |
| Change in fair value | – | (889) | 188 | 21 | (680) |
| Income statement transfers in respect of disposals | – | (842) | 165 | 48 | (629) |

| | | | | | |
|---|---|---|---|---|---|
| Income statement transfers in respect of impairment | – | – | 44 | (26) | 18 |
| Taxation | – | 366 | (106) | 17 | 277 |
| | – | (1,365) | 291 | 60 | (1,014) |
| Movements in cash flow hedging reserve: | | | | | |
| Effective portion of changes in fair value | – | 21 | (68) | (1,182) | (1,229) |
| Net income statement transfers | – | – | (393) | (157) | (550) |
| Taxation | – | (5) | 143 | 236 | 374 |
| | – | 16 | (318) | (1,103) | (1,405) |
| Currency translation differences (tax: nil) | – | (26) | 17 | 3 | (6) |
| Other comprehensive income for the year, net of tax | – | (1,055) | (438) | (1,040) | (2,533) |
| Total comprehensive income for the year | (845) | 1,717 | 3,890 | (8,097) | (3,335) |
| Total comprehensive income attributable to non–controlling interests | – | – | 36 | – | 36 |
| Total comprehensive income attributable to equity shareholders | (845) | 1,717 | 3,854 | (8,097) | (3,371) |
| Total comprehensive income for the year | (845) | 1,717 | 3,890 | (8,097) | (3,335) |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| For the year ended 31 December 2012[1] | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| Loss for the year | (224) | (2,187) | 2,375 | (1,351) | (1,387) |
| Other comprehensive income | | | | | |
| Items that will not subsequently be reclassified to profit or loss: | | | | | |
| Post–retirement defined benefit scheme remeasurements: | | | | | |
| Remeasurements before taxation | – | (934) | (1,202) | – | (2,136) |
| Taxation | – | 215 | 276 | – | 491 |
| | – | (719) | (926) | – | (1,645) |
| Items that may subsequently be reclassified to profit or loss: | | | | | |
| Movements in revaluation reserve in respect of available–for– sale financial assets: | | | | | |
| Adjustment on transfer from held–to maturity portfolio | – | 1,168 | – | – | 1,168 |
| Change in fair value | – | 155 | 642 | 103 | 900 |
| Income statement transfers in respect of disposals | – | (3,118) | (318) | (111) | (3,547) |
| Income statement transfers in respect of impairment | – | – | 397 | (355) | 42 |
| Other income statement transfers | – | 169 | – | – | 169 |
| Taxation | – | 366 | (126) | 99 | 339 |
| | – | (1,260) | 595 | (264) | (929) |
| Movements in cash flow hedging reserve: | | | | | |
| Effective portion of changes in fair value | – | (5) | 731 | (610) | 116 |
| Net income statement transfers | – | – | (269) | 177 | (92) |
| Taxation | – | 1 | (83) | 83 | 1 |
| | – | (4) | 379 | (350) | 25 |
| Currency translation differences (tax: nil) | – | (21) | 34 | (27) | (14) |
| Other comprehensive income for the year, net of tax | – | (2,004) | 82 | (641) | (2,563) |
| Total comprehensive income for the year | (224) | (4,191) | 2,457 | (1,992) | (3,950) |
| Total comprehensive income attributable to non–controlling interests | – | – | 82 | – | 82 |
| Total comprehensive income attributable to equity shareholders | (224) | (4,191) | 2,375 | (1,992) | (4,032) |
| Total comprehensive income for the year | (224) | (4,191) | 2,457 | (1,992) | (3,950) |

[1]Restated – see note 1 on page F-11.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| For the year ended 31 December 2011[1] | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| (Loss) profit for the year | (168) | 2,623 | (1,987) | (1,022) | (554) |
| Other comprehensive income | | | | | |
| Items that will not subsequently be reclassified to profit or loss: | | | | | |
| Post–retirement defined benefit scheme remeasurements: | | | | | |
| Remeasurements before taxation | – | 86 | 538 | – | 624 |
| Taxation | – | (21) | (134) | – | (155) |
| | – | 65 | 404 | – | 469 |
| Items that may subsequently be reclassified to profit or loss: | | | | | |
| Movements in revaluation reserve in respect of available–for–sale financial assets: | | | | | |
| Change in fair value | – | 2,612 | 146 | 231 | 2,527 |
| Income statement transfers in respect of disposals | – | (234) | (58) | (51) | (343) |
| Income statement transfers in respect of impairment | – | – | 750 | (670) | 80 |
| Other income statement transfers | – | 18 | (97) | – | (79) |
| Taxation | – | (603) | (130) | 158 | (575) |
| | | 1,793 | 611 | (794) | 1,610 |
| Movements in cash flow hedging reserve: | | | | | |
| Effective portion of changes in fair value | – | (10) | 1,351 | (425) | 916 |
| Net income statement transfers | – | 8 | 374 | (312) | 70 |
| Taxation | – | – | (448) | 178 | (270) |
| | – | (2) | 1,277 | (559) | 716 |
| Currency translation differences (tax: nil) | – | 3 | (85) | (2) | (84) |
| Other comprehensive income for the year, net of tax | – | 1,859 | 2,207 | (1,355) | 2,711 |
| Total comprehensive income for the year | (168) | 4,482 | 220 | (2,377) | 2,157 |
| Total comprehensive income attributable to non–controlling interests | – | – | 72 | – | 72 |
| Total comprehensive income attributable to equity shareholders | (168) | 4,482 | 148 | (2,377) | 2,085 |
| Total comprehensive income for the year | (168) | 4,482 | 220 | (2,377) | 2,157 |

[1]Restated – see note 1 on page F-11.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

**BALANCE SHEETS**

| | Company | Lloyds Bank | Subsidiaries | Consolidation adjustments | Group |
|---|---|---|---|---|---|
| **At 31 December 2013** | **£m** | **£m** | **£m** | **£m** | **£m** |
| **Assets** | | | | | |
| Cash and balances at central banks | **–** | **42,283** | **7,632** | **–** | **49,915** |
| Items in course of collection from banks | **–** | **663** | **344** | **–** | **1,007** |
| Trading and other financial assets at fair value through profit or loss | **–** | **40,167** | **115,457** | **(12,941)** | **142,683** |
| Derivative financial instruments | **1,452** | **30,392** | **22,440** | **(21,159)** | **33,125** |
| Loans and receivables: | | | | | |
| Loans and advances to banks | **–** | **3,095** | **22,247** | **23** | **25,365** |
| Loans and advances to customers | **–** | **167,903** | **325,249** | **2,129** | **495,281** |
| Debt securities | **–** | **150** | **1,130** | **75** | **1,355** |
| Due from fellow Lloyds Banking Group undertakings | **8,505** | **262,977** | **249,334** | **(520,816)** | **–** |
| Available-for-sale financial assets | **3,116** | **41,348** | **38,511** | **(38,999)** | **43,976** |
| Investment properties | **–** | **–** | **4,864** | **–** | **4,864** |
| Goodwill | **–** | **–** | **2,352** | **(336)** | **2,016** |
| Value of in-force business | **–** | **–** | **5,254** | **81** | **5,335** |
| Other intangible assets | **–** | **564** | **239** | **1,476** | **2,279** |
| Tangible fixed assets | **–** | **2,627** | **4,876** | **67** | **7,570** |
| Current tax recoverable | **19** | **1,646** | **170** | **(1,804)** | **31** |
| Deferred tax assets | **4** | **4,165** | **3,669** | **(2,734)** | **5,104** |
| Retirement benefit assets | **–** | **–** | **39** | **59** | **98** |
| Investment in subsidiary undertakings | **40,933** | **40,929** | **–** | **(81,862)** | **–** |
| Other assets | **1,171** | **1,857** | **24,885** | **(887)** | **27,026** |
| **Total assets** | **55,200** | **640,766** | **828,692** | **(677,561)** | **847,030** |
| **Equity and liabilities** | | | | | |
| **Liabilities** | | | | | |
| Deposits from banks | **–** | **10,448** | **3,536** | **(2)** | **13,982** |
| Customer deposits | **–** | **187,399** | **253,939** | **(27)** | **441,311** |
| Due to fellow Lloyds Banking Group undertakings | **14,820** | **244,025** | **261,078** | **(519,923)** | **–** |
| Items in course of transmission to banks | **–** | **432** | **342** | **–** | **774** |
| Trading and other financial liabilities at fair value through profit or loss | **–** | **43,106** | **26,278** | **(25,759)** | **43,625** |
| Derivative financial instruments | **–** | **31,114** | **20,509** | **(21,159)** | **30,464** |
| Notes in circulation | **–** | **–** | **1,176** | **–** | **1,176** |
| Debt securities in issue | **535** | **53,195** | **42,603** | **(9,231)** | **87,102** |
| | **–** | **–** | **82,809** | **(32)** | **82,777** |

| | | | | | |
|---|---|---|---|---|---|
| Liabilities arising from insurance contracts and participating investment contracts | | | | | |
| Liabilities arising from non-participating investment contracts | **–** | **–** | **27,590** | **–** | **27,590** |
| Unallocated surplus within insurance businesses | **–** | **–** | **391** | **–** | **391** |
| Other liabilities | **459** | **4,406** | **38,066** | **(2,298)** | **40,607** |
| Retirement benefit obligations | **–** | **413** | **521** | **162** | **1,096** |
| Current tax liabilities | **–** | **5** | **1,843** | **(1,701)** | **147** |
| Deferred tax liabilities | **–** | **–** | **1,443** | **(1,440)** | **3** |
| Other provisions | **–** | **2,485** | **1,822** | **30** | **4,337** |
| Subordinated liabilities | **1,669** | **22,600** | **26,384** | **(18,341)** | **32,312** |
| **Total liabilities** | **17,483** | **599,628** | **790,319** | **(599,736)** | **807,694** |
| **Equity** | | | | | |
| Shareholders' equity | **37,717** | **41,138** | **37,959** | **(77,825)** | **38,989** |
| Non-controlling interests | **–** | **–** | **347** | **–** | **347** |
| **Total equity** | **37,717** | **41,138** | **38,306** | **(77,825)** | **39,336** |
| **Total equity and liabilities** | **55,200** | **640,766** | **828,692** | **(677,561)** | **847,030** |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| At 31 December 20121 | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances at central banks | – | 74,078 | 6,220 | – | 80,298 |
| Items in course of collection from banks | – | 806 | 450 | – | 1,256 |
| Trading and other financial assets at fair value through profit or loss | – | 6,462 | 154,944 | (786) | 160,620 |
| Derivative financial instruments | 1,693 | 32,247 | 37,705 | (15,088) | 56,557 |
| Loans and receivables: | | | | | |
| Loans and advances to banks | – | 188,216 | 255,075 | (410,534) | 32,757 |
| Loans and advances to customers | 7,418 | 240,546 | 345,347 | (76,086) | 517,225 |
| Debt securities | – | 492 | 25,455 | (20,674) | 5,273 |
| Available-for-sale financial assets | 3,083 | 31,092 | 17,898 | (20,699) | 31,374 |
| Investment properties | – | – | 5,405 | – | 5,405 |
| Goodwill | – | – | 2,874 | (858) | 2,016 |
| Value of in-force business | – | – | 5,654 | 1,146 | 6,800 |
| Other intangible assets | – | 411 | 272 | 2,109 | 2,792 |
| Tangible fixed assets | – | 2,186 | 5,098 | 58 | 7,342 |
| Current tax recoverable | – | 1,102 | 718 | (1,466) | 354 |
| Deferred tax assets | 9 | 4,188 | 4,172 | (3,456) | 4,913 |
| Retirement benefit assets | – | 3 | 474 | 264 | 741 |
| Investment in subsidiary undertakings | 40,534 | 39,958 | – | (80,492) | – |
| Other assets | 974 | 1,547 | 17,304 | (1,327) | 18,498 |
| Total assets | 53,711 | 623,334 | 885,065 | (627,889) | 934,221 |
| **Equity and liabilities** | | | | | |
| **Liabilities** | | | | | |
| Deposits from banks | – | 214,725 | 252,545 | (428,865) | 38,405 |
| Customer deposits | 10,630 | 231,773 | 243,785 | (59,276) | 426,912 |
| Items in course of transmission to banks | – | 445 | 551 | – | 996 |
| Trading and other financial liabilities at fair value through profit or loss | – | 10,841 | 22,551 | – | 33,392 |
| Derivative financial instruments | – | 30,616 | 33,064 | (15,004) | 48,676 |
| Notes in circulation | – | – | 1,198 | – | 1,198 |
| Debt securities in issue | 545 | 61,494 | 75,282 | (20,068) | 117,253 |
| Liabilities arising from insurance contracts and participating investment contracts | – | – | 82,972 | (19) | 82,953 |
| Liabilities arising from non-participating investment contracts | – | – | 54,372 | – | 54,372 |
| Unallocated surplus within insurance businesses | – | – | 267 | – | 267 |
| Other liabilities | 111 | 4,524 | 44,254 | (2,096) | 46,793 |
| Retirement benefit obligations | – | 1,121 | 638 | 146 | 1,905 |

| | | | | | |
|---|---|---|---|---|---|
| Current tax liabilities | 266 | 10 | 1,419 | (1,557) | 138 |
| Deferred tax liabilities | – | – | 1,903 | (1,576) | 327 |
| Other provisions | – | 2,371 | 1,581 | 9 | 3,961 |
| Subordinated liabilities | 4,349 | 26,249 | 26,871 | (23,377) | 34,092 |
| **Total liabilities** | 15,901 | 584,169 | 843,253 | (551,683) | 891,640 |
| **Equity** | | | | | |
| Shareholders’ equity | 37,810 | 39,165 | 41,127 | (76,206) | 41,896 |
| Non-controlling interests | – | – | 685 | – | 685 |
| Total equity | 37,810 | 39,165 | 41,812 | (76,206) | 42,851 |
| Total equity and liabilities | 53,711 | 623,334 | 885,065 | (627,889) | 934,221 |

[1] Restated – see note 1 on page F-11.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| For the year ended 31 December 2013 | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| **Net cash provided by (used in) operating activities** | **3,835** | **(9,520)** | **(10,301)** | **455** | **(15,531)** |
| Cash flows from investing activities | | | | | |
| Available-for-sale financial assets | | | | | |
| Purchases | – | (30,009) | (3,743) | (3,207) | (36,959) |
| Proceeds from sale and maturity | – | 16,671 | 9,885 | (5,004) | 21,552 |
| Purchase of fixed assets | – | (1,093) | (1,889) | – | (2,982) |
| Proceeds from sale of fixed assets | – | 22 | 2,068 | – | 2,090 |
| Additional capital lending to subsidiaries | (3,082) | – | – | 3,082 | – |
| Capital repayments by subsidiaries | 197 | – | – | (197) | – |
| Additional capital injections to subsidiaries | – | (621) | – | 621 | – |
| Acquisition of businesses, net of cash acquired | – | (773) | (6) | 773 | (6) |
| Disposal of businesses, net of cash disposed | – | (9) | 1,491 | (786) | 696 |
| **Net cash flows from investing activities** | **(2,885)** | **(15,812)** | **7,806** | **(4,718)** | **(15,609)** |
| Cash flows from financing activities | | | | | |
| Dividends paid to non-controlling interests | – | – | (25) | – | (25) |
| Interest paid on subordinated liabilities | (253) | (1,694) | (1,898) | 1,394 | (2,451) |
| Proceeds from issue of subordinated liabilities | – | | 1,500 | – | 1,500 |
| Repayment of subordinated liabilities | (2,767) | (3,539) | (1,149) | 5,013 | (2,442) |
| Proceeds from issue of ordinary shares | 350 | – | – | – | 350 |
| Capital contribution received | – | – | 621 | (621) | – |
| Capital repayments to the Company | – | – | (197) | 197 | – |
| Change in stake of non-controlling interests | – | – | – | – | – |
| **Net cash used in financing activities** | **(2,670)** | **(5,233)** | **(1,148)** | **5,983** | **(3,068)** |
| Effects of exchange rate changes on cash and cash equivalents | – | (52) | (1) | – | (53) |
| **Change in cash and cash equivalents** | **(1,720)** | **(30,617)** | **(3,644)** | **1,720** | **(34,261)** |
| Cash and cash equivalents at beginning of year | 2,231 | 75,108 | 25,950 | (2,231) | 101,058 |
| **Cash and cash equivalents at end of year** | **511** | **44,491** | **22,306** | **(511)** | **66,797** |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| For the year ended 31 December 2012 | Company £m | Lloyds Bank £m | Subsidiaries £m | Consolidation adjustments £m | Group £m |
|---|---|---|---|---|---|
| Net cash provided by (used in) operating activities | 1,040 | (9,5 | 6,010 | (12,823) | 3,049 |
| Cash flows from investing activities | | | | | |
| Available-for-sale financial assets and held-to-maturity investments | | | | | |
| Purchases | – | (18,825) | (13,991) | 10,766 | (22,050) |
| Proceeds from sale and maturity | – | 28,490 | 9,486 | (312) | 37,664 |
| Purchase of fixed assets | – | (1,042) | (1,961) | – | (3,003) |
| Proceeds from sale of fixed assets | – | 15 | 2,580 | – | 2,595 |
| Additional capital injections to subsidiaries | – | (37) | – | 37 | – |
| Capital repayments by subsidiaries | 209 | – | – | (209) | – |
| Acquisition of businesses, net of cash acquired | – | – | (371) | 360 | (11) |
| Disposal of businesses, net of cash disposed | – | 362 | 37 | (362) | 37 |
| Net cash flows from investing activities | 209 | 8,963 | (4,220) | 10,280 | 15,232 |
| Cash flows from financing activities | | | | | |
| Dividends paid to non-controlling interests | – | – | (56) | – | (56) |
| Interest paid on subordinated liabilities | (293) | (1,442) | (1,887) | 1,045 | (2,577) |
| Repayment of subordinated liabilities | – | (215) | (649) | 200 | (664) |
| Proceeds from issue of ordinary shares | 170 | – | – | – | 170 |
| Capital contribution received | – | – | 37 | (37) | – |
| Capital repayments to the Company | – | – | (209) | 209 | – |
| Change in stake of non-controlling interests | – | – | 23 | – | 23 |
| Net cash used in financing activities | (123) | (1,657) | (2,741) | 1,417 | (3,104) |
| Effects of exchange rate changes on cash and cash equivalents | – | (5) | (3) | – | (8) |
| Change in cash and cash equivalents | 1,126 | 16,123 | (954) | (1,126) | 15,169 |
| Cash and cash equivalents at beginning of year | 1,105 | 58,949 | 26,940 | (1,105) | 85,889 |
| Cash and cash equivalents at end of year | 2,231 | 75,072 | 25,986 | (2,231) | 101,058 |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 59: CONDENSED CONSOLIDATING FINANCIAL INFORMATION** continued

| | Company | Lloyds Bank | Subsidiaries | Consolidation adjustments | Group |
|---|---|---|---|---|---|
| For the year ended 31 December 2011 | £m | £m | £m | £m | £m |
| Net cash provided by (used in) operating activities | 3,109 | 23,038 | (13) | (6,241) | 19,893 |
| Cash flows from investing activities | | | | | |
| Additional capital injection into Lloyds Bank plc | (2,340) | – | – | 2,340 | – |
| Available-for-sale financial assets and held-to-maturity investments | | | | | |
| Purchases | – | (20,062) | (11,188) | 2,255 | (28,995) |
| Proceeds from sale and maturity | – | 15,918 | 20,605 | – | 36,523 |
| Purchase of fixed assets | – | (847) | (2,248) | – | (3,095) |
| Proceeds from sale of fixed assets | – | 35 | 2,179 | – | 2,214 |
| Additional capital injections to subsidiaries | – | (159) | – | 159 | – |
| Acquisition of businesses, net of cash acquired | – | – | (13) | – | (13) |
| Disposal of businesses, net of cash disposed | – | 4 | 298 | (4) | 298 |
| Net cash flows from investing activities | (2,340) | (5,111) | 9,633 | 4,750 | 6,932 |
| Cash flows from financing activities | | | | | |
| Dividends paid to non-controlling interests | – | – | (50) | – | (50) |
| Interest paid on subordinated liabilities | (39) | (630) | (2,013) | 556 | (2,126) |
| Repayment of subordinated liabilities | – | (1,082) | (2,696) | 2,704 | (1,074) |
| Capital contribution received | – | 2,340 | 159 | (2,499) | – |
| Change in stake of non-controlling interests | – | – | 8 | – | 8 |
| Net cash used in financing activities | (39) | 628 | (4,592) | 761 | (3,242) |
| Effects of exchange rate changes on cash and cash equivalents | – | 5 | 1 | – | 6 |
| Change in cash and cash equivalents | 730 | 18,560 | 5,029 | (730) | 23,589 |
| Cash and cash equivalents at beginning of year | 375 | 40,389 | 21,911 | (375) | 62,300 |
| Cash and cash equivalents at end of year | 1,105 | 58,949 | 26,940 | (1,105) | 85,889 |

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GLOSSARY

| **Term used** | **US equivalent or brief description.** |
|---|---|
| Accounts | Financial statements. |
| Allotted | Issued. |
| Associates | Long-term equity investments accounted for by the equity method. |
| Attributable profit | Net income. |
| ATM | Automatic Teller Machine. |
| ATM interchange | System allowing customers of different ATM operators to use any ATM that is part of the system. |
| Balance sheet | Statement of financial position. |
| Broking | Brokerage. |
| Building society | A building society is a mutual institution set up to lend money to its members for house purchases.<br>See also 'Demutualisation'. |
| Buy-to-let mortgages | Buy-to-let mortgages are those mortgages offered to customers purchasing residential property as a rental investment. |
| Called-up share capital | Ordinary shares, issued and fully paid. |
| Contract hire | Leasing. |
| Creditors | Payables. |
| Debtors | Receivables. |
| Deferred tax | Deferred income tax. |
| Demutualisation | Process by which a mutual institution is converted into a public limited company. |
| Depreciation | Amortisation. |
| Endowment mortgage | An interest-only mortgage to be repaid by the proceeds of an endowment insurance policy which is assigned to the lender providing the mortgage. The sum insured, which is payable on maturity or upon the death of the policyholder, is used to repay the mortgage. |
| Finance lease | Capital lease. |
| Freehold | Ownership with absolute rights in perpetuity. |
| ISA | Individual Savings Account. |
| Leasehold | Land or property which is rented from the owner for a specified term under a lease. At the expiry of the term the land or property reverts back to the owner. |
| Lien | Under UK law, a right to retain possession pending payment. |
| Life assurance | Life insurance. |
| Loan capital | Long-term debt. |
| Members | Shareholders. |
| Memorandum and articles of association | Articles and bylaws. |
| National Insurance | A form of taxation payable in the UK by employees, employers and the self-employed, used to fund benefits at the national level including state pensions, medical benefits through the National Health Service (NHS), unemployment and maternity. It is part of the UK's national social security system and ultimately controlled by HM Revenue & Customs. |
| Nominal value | Par value. |
| Open Ended Investment Company (OEIC) | Mutual fund. |
| Ordinary shares | Common stock. |
| Overdraft | |

| | |
|---|---|
| | A line of credit, contractually repayable on demand unless a fixed-term has been agreed, established through a customer's current account. |
| Preference shares | Preferred stock. |

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GLOSSARY

| Term used | US equivalent or brief description. |
|---|---|
| Premises | Real estate. |
| Profit attributable to equity shareholders | Net income. |
| Provisions | Reserves. |
| Regular premium | Premiums which are payable throughout the duration of a policy or for some shorter fixed period. |
| Reinsurance | The insuring again by an insurer of the whole or part of a risk that it has already insured with another insurer called a reinsurer. |
| Retained profits | Retained earnings. |
| Share capital | Capital stock. |
| Shareholders' equity | Stockholders' equity. |
| Share premium account | Additional paid-in capital. |
| Shares in issue | Shares outstanding. |
| Single premium | A premium in relation to an insurance policy payable once at the commencement of the policy. |
| Specialist mortgages | Specialist mortgages include those mortgage loans provided to customers who have self-certified their income (normally as a consequence of being self-employed) or who are otherwise regarded as a sub-prime credit risk. New mortgage lending of this type has not been offered by the Group since early 2009. |
| Tangible fixed assets | Property and equipment. |
| Undistributable reserves | Restricted surplus. |
| Write-offs | Charge-offs. |

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FORM 20-F CROSS REFERENCE SHEET

FORM 20-F CROSS REFERENCE SHEET

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EXHIBIT INDEX

1. Memorandum and articles of association of Lloyds Banking Group plc

2. Neither Lloyds Banking Group plc nor any subsidiary is party to any single long-term debt instrument pursuant to which a total amount of securities exceeding 10 per cent of the Group's total assets (on a consolidated basis) is authorised to be issued. Lloyds Banking Group plc hereby agrees to furnish to the Securities and Exchange Commission (the Commission), upon its request, a copy of any instrument defining the rights of holders of its long-term debt or the rights of holders of the long-term debt issued by it or any subsidiary for which consolidated or unconsolidated financial statements are required to be filed with the Commission.

4. (a) (i) Registration Rights Agreement dated 12 January 2009 between Lloyds Banking Group plc and The Commissioners of Her Majesty's Treasury (as amended with effect from 11 June 2009)
(ii) Resale Rights Agreement effective 11 June 2009 between Lloyds Banking Group plc and The Commissioners of Her Majesty's Treasury
(iii) Deed of Withdrawal dated 3 November 2009 between Lloyds Banking Group plc and The Lords Commissioners of Her Majesty's Treasury[2]

4. (b) (i) Service agreement dated 3 November 2010 between Lloyds Bank plc and António Horta-Osório[o]
(ii) Letter of appointment dated 7 August 2008 between Lloyds Banking Group plc and Martin A. Scicluna[†]
(iii) Letter of appointment dated 23 February 2009 between Lloyds Banking Group plc and T. Timothy Ryan[†]
(iv) Letter of appointment dated 23 February 2009 between Lloyds Banking Group plc and Anthony Watson[†]
(v) Letter of appointment dated 27 July 2009 between Lloyds Banking Group plc and Sir Winfried Bischoff
(vi) Letter of appointment dated 12 February 2010 between Lloyds Banking Group plc and David Roberts
(vii) Letter of appointment dated 23 November 2010 between Lloyds Banking Group plc and Anita Frew[o]
(viii) Letter of appointment dated 31 January 2012 between Lloyds Banking Group plc and Sara Weller
(ix) Service agreement dated 1 March 2012 between Lloyds Bank plc and George Culmer[r]
(x) Letter of appointment dated 25 May 2012 between Lloyds Banking Group plc and Lord Blackwell[r]
(xi) Letter of appointment dated 28 May 2012 between Lloyds Banking Group plc and Carolyn Fairbairn[r]
(xii) Letter of appointment dated 25 February 2013 between Lloyds Banking Group plc and Nick Luff[r]
(xiii) Letter of appointment dated 28 October 2013 between Lloyds Banking Group plc and Dyfrig John
(xiv) Service agreement dated 30 November 2010 between Lloyds Bank plc and Juan Colombás

8.1 List of subsidiaries, their jurisdiction of incorporation and the names under which they conduct business

12.1 Certification of António Horta-Osório filed pursuant to 17 CFR 240.13a-14(a) and 15 U.S.C. 7241

12.2 Certification of George Culmer filed pursuant to 17 CFR 240.13a-14(a) and 15 U.S.C. 7241

13.1 Certification of António Horta-Osório and George Culmer furnished pursuant to 17 CFR 240.13a-14(b) and 18 U.S.C. 1350

15.1 Consent of PricewaterhouseCoopers LLP

† Previously filed with the SEC on Lloyds Banking Group's Form 20–F filed 7 May 2009
Previously filed with the SEC on Lloyds Banking Group's Form 20–F filed 13 May 2010
o Previously filed with the SEC on Lloyds Banking Group's Form 20–F filed 13 May 2011
Previously filed with the SEC on Lloyds Banking Group's Form 20–F filed 16 March 2012
r Previously filed with the SEC on Lloyds Banking Group's Form 20–F filed 25 March 2013
2 Pursuant to a request for confidential treatment filed with the SEC, the confidential portions of this exhibit have been omitted and filed separately with the SEC.

The exhibits shown above are listed according to the number assigned to them by the Form 20–F.

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SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorised the undersigned to sign this annual report on its behalf.

LLOYDS BANKING GROUP plc

| | |
|---|---|
| By: | /s/ G Culmer |
| Name: | George Culmer |
| Title: | Chief Financial Officer |
| Dated: | 5 March 2014 |

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