Lloyds Banking Group plc
Form 20-F
March 09, 2018

As filed with the Securities and Exchange Commission on 9 March 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934
OR
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended 31 December 2017
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
OR
o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 001-15246

LLOYDS BANKING GROUP plc

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

Scotland
(Jurisdiction of Incorporation or Organization)

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

Malcolm Wood, Company Secretary
Tel +44 (0) 20 7356 1274, Fax +44 (0) 20 7356 1808
25 Gresham Street
London EC2V 7HN
United Kingdom
(Name, telephone, e-mail and/or facsimile number and address of Company contact person)

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

Title of each class	Name of each exchange on which registered
Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares	The New York Stock Exchange
$1,500,000,000 4.344% Subordinated Securities due in 2048	The New York Stock Exchange
$824,033,000 5.3% Subordinated Securities due 2045	The New York Stock Exchange
$1,750,000,000 3.574% Senior Notes due in 2028 (callable in 2027)	The New York Stock Exchange
$1,250,000,000 3.75% Senior Notes due 2027	The New York Stock Exchange
$1,500,000,000 4.65% Subordinated Securities due 2026	The New York Stock Exchange
$1,327,685,000 4.582% Subordinated Securities due 2025	The New York Stock Exchange
$1,250,000,000 3.5% Senior Notes due 2025	The New York Stock Exchange
$1,000,000,000 4.5% Subordinated Securities due 2024	The New York Stock Exchange
$2,250,000,000 2.907% Senior Notes due 2023 (callable in 2022)	The New York Stock Exchange
$1,500,000,000 3.0% Senior Notes due 2022	The New York Stock Exchange
$1,000,000,000 3.1% Senior Notes due 2021	The New York Stock Exchange
$2,500,000,000 6.375% Senior Notes due 2021	The New York Stock Exchange
$1,000,000,000 2.7% Senior Notes due 2020	The New York Stock Exchange
$1,000,000,000 2.4% Senior Notes due 2020	The New York Stock Exchange
$1,000,000,000 2.35% Senior Notes due 2019	The New York Stock Exchange
$750,000,000 2.05% Senior Notes due 2019	The New York Stock Exchange
$450,000,000 Floating Rate Notes due 2019	The New York Stock Exchange
$1,000,000,000 2.3% Senior Notes due 2018	The New York Stock Exchange
$700,000,000 2% Senior Notes due 2018	The New York Stock Exchange
$300,000,000 Floating Rate Notes due 2018	The New York Stock Exchange
$1,250,000,000 1.75% Senior Notes due 2018	The New York Stock Exchange
$400,000,000 Floating Rate Notes due 2018	The New York Stock Exchange
$1,000,000,000 1.75% Senior Notes due 2018	The New York Stock Exchange
$500,000,000 Floating Rate Notes due 2018	The New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act:
None
Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:
7.50% Fixed Rate Reset Additional Tier 1 Perpetual Subordinated Contingent Convertible Securities

The number of outstanding shares of each of Lloyds Banking Group plc's classes of capital or common stock as of 31 December 2017 was:

Ordinary shares, nominal value 10 pence each	71,972,949,589
Preference shares, nominal value 25 pence each	412,204,151
Preference shares, nominal value 25 cents each	809,160
Preference shares, nominal value 25 euro cents each	Nil

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes x No o

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
Yes o No x

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or an emerging growth company. See definitions of "large accelerated filer", "accelerated filer," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer x Accelerated filer o Non-Accelerated filer o Emerging Growth Company o

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards[†]provided pursuant to Section 13(a) of the Exchange Act.
Yes o No o

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

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

If 'Other' has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:
Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

†The term "new or revised financial accounting standard" refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after April 5, 2012.

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PRESENTATION OF INFORMATION

In this annual report, references to the ‘Company’ are to Lloyds Banking Group plc; references to ‘Lloyds Banking Group’, ‘Lloyds’ or the ‘Group’ are to Lloyds Banking Group plc and its subsidiary and associated undertakings; references to ‘Lloyds Bank’ are to Lloyds Bank plc (previously Lloyds TSB Bank plc); and references to the ‘consolidated financial statements’ or ‘financial statements’ are to Lloyds Banking Group’s consolidated financial statements included in this annual report. References to the ‘Financial Conduct Authority’ or ‘FCA’ and to the ‘Prudential Regulation Authority’ or ‘PRA’ are to the United Kingdom (the UK) Financial Conduct Authority and the UK Prudential Regulation Authority. References to the ‘Financial Services Authority’ or ‘FSA’ are to their predecessor organisation, the UK Financial Services Authority.

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds ('pounds sterling', 'sterling' or '£'), the lawful currency of the UK. In this annual report, references to 'pence' and 'p' are to one-hundredth of one pound sterling; references to 'US dollars', 'US$' or '$' are to the lawful currency of the United States (the US); references to 'cent' or 'c' are to one-hundredth of one US dollar; references to 'euro' or '€' are to the lawful currency of the member states of the European Union (EU) that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to 'euro cent' are to one-hundredth of one euro; and references to 'Japanese yen', 'Japanese ¥' or '¥' are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2017, which was $1.3529 = £1.00. The Noon Buying Rate on 31 December 2017 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

BUSINESS OVERVIEW

Lloyds Banking Group is a leading provider of financial services to individual and business customers in the UK. At 31 December 2017, total Lloyds Banking Group assets were £812,109 million and Lloyds Banking Group had 67,905 employees (on a full-time equivalent basis). Lloyds Banking Group plc's market capitalisation at that date was £48,985 million. The Group reported a profit before tax for the 12 months to 31 December 2017 of £5,625 million, and its capital ratios at that date were 21.2 per cent for total capital, 17.2 per cent for tier 1 capital and 14.1 per cent for common equity tier 1 capital.

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

	2017	2016	2015
	£m	£m	£m
Net interest income	10,912	9,274	11,318
Other income	23,325	30,337	11,832
Total income	34,237	39,611	23,150
Insurance claims	(15,578)	(22,344)	(5,729)
Total income, net of insurance claims	18,659	17,267	17,421
Operating expenses	(12,346)	(12,627)	(15,387)
Trading surplus	6,313	4,640	2,034
Impairment	(688)	(752)	(390)
Profit before tax	5,625	3,888	1,644

Lloyds Banking Group's main business activities are retail and commercial banking and long-term savings, protection and investment and it operates primarily in the UK. Services are offered through a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows, and through a range of distribution channels including the largest branch network and digital bank in the UK.

At 31 December 2017, the Group's three primary operating divisions, which are also reporting segments, were: Retail; Commercial Banking; and Insurance and Wealth. Retail provides banking, mortgages, personal loans, motor finance, credit cards and other financial services to personal and small business customers. Commercial Banking provides banking and related services to business clients, from SMEs to large corporates. Insurance and Wealth provides long-term savings, protection and investment products as well as general insurance products.

Profit before tax is analysed on pages 13 to 22 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group's segments, on pages 24 to 32 on an underlying basis. The key principles adopted in the preparation of this basis of reporting are described on page 24. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources; this reporting is on an underlying basis. IFRS 8, *Operating Segments* requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements in compliance with IFRS 8. The table below shows the results of Lloyds Banking Group's segments in the last three fiscal years, and their aggregation. Further information on non-GAAP measures and the reconciliations required by the Securities and Exchange Commission's Regulation G are set out on pages F-18 to F-21.

	2017	2016[1]	2015[1]
	£m	£m	£m
Retail	4,403	4,058	4,255
Commercial Banking	2,489	2,379	2,383
Insurance and Wealth	939	973	1,090
Other	662	457	384
Profit before tax – underlying basis	8,493	7,867	8,112

1 Segmental analysis restated, as explained on page 24.

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

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SELECTED CONSOLIDATED FINANCIAL DATA

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

	2017	2016	2015	2014	2013
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	18,659	17,267	17,421	16,399	18,478
Operating expenses	(12,346)	(12,627)	(15,387)	(13,885)	(15,322)
Trading surplus	6,313	4,640	2,034	2,514	3,156
Impairment losses	(688)	(752)	(390)	(752)	(2,741)
Profit before tax	5,625	3,888	1,644	1,762	415
Profit (loss) for the year	3,897	2,164	956	1,499	(802)
Profit (loss) for the year attributable to ordinary shareholders	3,392	1,651	466	1,125	(838)
Dividends for the year[1,2]	2,195	2,175	1,962	535	–
Balance sheet data at 31 December (£m)					
Share capital	7,197	7,146	7,146	7,146	7,145
Shareholders’ equity	43,551	42,670	41,234	43,335	38,989
Other equity instruments	5,355	5,355	5,355	5,355	–
Customer deposits	418,124	415,460	418,326	447,067	439,467
Subordinated liabilities	17,922	19,831	23,312	26,042	32,312
Loans and advances to customers	472,498	457,958	455,175	482,704	492,952
Total assets	812,109	817,793	806,688	854,896	842,380
Share information					
Basic earnings (loss) per ordinary share	4.9p	2.4p	0.8p	1.7p	(1.2)p
Diluted earnings (loss) per ordinary share	4.8p	2.4p	0.8p	1.6p	(1.2)p
Net asset value per ordinary share	60.5p	59.8p	57.9p	60.7p	54.6p
Dividends per ordinary share[1,3]	3.05p	3.05p	2.75p	0.75p	–
Equivalent cents per share[1,3,4]	4.21c	3.95c	4.03c	1.16c	–
Market price per ordinary share (year end)	68.1p	62.5p	73.1p	75.8p	78.9p
Number of shareholders (thousands)	2,450	2,510	2,563	2,626	2,681
Number of ordinary shares in issue (millions)[5]	71,973	71,374	71,374	71,374	71,368
Financial ratios (%)[6]					
Dividend payout ratio[7]	62.8	124.9	359.3	45.1	–
Post-tax return on average shareholders’ equity	8.0	4.1	1.3	2.9	(2.0)
Post-tax return on average assets	0.48	0.26	0.11	0.17	(0.09)
Average shareholders’ equity to average assets	5.3	5.2	5.1	4.7	4.7
Cost:income ratio[8]	66.2	73.1	88.3	84.7	82.9
Capital ratios (%)[9,10]					
Total capital	21.2	21.2	21.5	22.0	20.8
Tier 1 capital	17.2	16.8	16.4	16.5	14.5
Common equity tier 1 capital/Core tier 1 capital	14.1	13.4	12.8	12.8	14.0

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

2 Dividends for the year in 2016 included a special dividend totalling £356 million; (2015: £357 million).

3 Dividends per ordinary share in 2016 included a recommended special dividend of 0.5 pence; (2015: 0.5 pence).

4 Translated into US dollars at the Noon Buying Rate on the date each payment was made, with the exception of the final dividend in respect of 2017, which has been translated at the Noon Buying Rate on 23 February 2018.

5 For 2016 and previous years, this figure excluded the limited voting ordinary shares owned by the Lloyds Bank Foundations. The limited voting ordinary shares were redesignated as ordinary shares on 1 July 2017.

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

7 Total dividend for the year divided by earnings attributable to ordinary shareholders adjusted for tax relief on distributions to other equity holders.

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

9 Capital ratios for 2013 are in accordance with the modified Basel II framework as implemented by the PRA.

10 Capital ratios for 2014 and later years are in accordance with the CRD IV rules implemented by the PRA on 1 January 2014.

EXCHANGE RATES

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

	2018 January	**2017 December**	**2017 November**	**2017 October**	**2017 September**	**2017 August**
US dollars per pound sterling:						
High	**1.43**	**1.35**	**1.35**	**1.33**	**1.36**	1.32
Low	**1.35**	**1.33**	**1.31**	**1.31**	**1.30**	1.28

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

	2017	2016	2015	2014	2013
US dollars per pound sterling:					
Average	**1.30**	1.34	1.53	1.65	1.57

On 23 February 2018, the latest practicable date, the US dollar Noon Buying Rate was $1.3979 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

The HBOS Group had been formed in September 2001 by the merger of Halifax plc and Bank of Scotland. The Halifax business began with the establishment of the Halifax Permanent Benefit Building Society in 1852; the society grew through a number of mergers and acquisitions including the merger with Leeds Permanent Building Society in 1995 and the acquisition of Clerical Medical in 1996. In 1997 the Halifax converted to plc status and floated on the London stock market. Bank of Scotland was founded in July 1695, making it Scotland’s first and oldest bank.

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company’s issued ordinary share capital. Following sales of shares in September 2013 and March 2014 and the completion of trading plans with Morgan Stanley & Co. International plc (Morgan Stanley), the UK Government completed the sale of its shares in May 2017, returning the Group to full private ownership.

Pursuant to its decision approving state aid to the Group, the European Commission required the Group to dispose of a retail banking business meeting minimum requirements for the number of branches, share of the UK personal current accounts market and proportion of the Group’s mortgage assets. Following disposals in 2014, the Group sold its remaining interest in TSB to Banco de Sabadell (Sabadell) in 2015, and all EC state aid requirements were met by 30 June 2017.

On 1 June 2017, following the receipt of competition and regulatory approval, the Group acquired 100 per cent of the ordinary share capital of MBNA Limited, which together with its subsidiaries operates a UK consumer credit card business, from FIA Jersey Holdings Limited, a wholly-owned subsidiary of Bank of America.

BUSINESS

STRATEGY OF LLOYDS BANKING GROUP

The Group is a leading provider of financial services to individual and business customers in the UK. The Group's main business activities are retail and commercial banking, and long-term savings, protection and investment. Services are provided through a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows and through a range of distribution channels, including the largest branch network and digital bank in the UK.

In 2017 the Group successfully completed the second phase of its strategic plan, which focussed on creating the best customer experience, becoming simpler and more efficient and delivering sustainable growth.

As the Group looks to the future, it sees the external environment evolving rapidly. Changing customer behaviours, the pace of technological evolution and changes in regulation all present opportunities. Given the Group's strong capabilities and the significant progress made in recent years the Group believes it is in a unique position to compete and win in this environment by developing additional competitive advantages. The Group will continue to transform itself to succeed in this digital world and the next phase of its strategy will ensure the Group has the capabilities to deliver future success.

STRATEGIC PRIORITIES

The Group has identified four strategic priorities focused on the financial needs and behaviours of the customer of the future: further enhancing the Group's leading customer experience; further digitising the Group; maximising Group capabilities; and transforming ways of working. The Group will invest more than £3 billion in these strategic initiatives through the plan period that will drive the Group's transformation into a digitised, simple, low risk, customer focused UK financial services provider.

Delivering a leading customer experience

The Group will drive stronger customer relationships through best in class propositions while continuing to provide the Group's customers with brilliant servicing and a seamless experience across all channels. This will include:

- remaining the number 1 digital bank in the UK with open banking functionality;
- unrivalled reach with UK's largest branch network serving complex needs; and
- data-driven and personalised customer propositions.

Digitising the Group

The Group will deploy new technology to drive additional operational efficiencies that will make banking simple and easier for customers whilst reducing operating costs, pursuing the following initiatives:

- deeper end-to-end transformation targeting over 70 per cent of cost base;
- simplification and progressive modernisation of our data and IT infrastructure; and
- technology enabled productivity improvements across the business.

Maximising the Group's capabilities

The Group will deepen customer relationships, grow in targeted segments and better address our customers' banking and insurance needs as an integrated financial services provider. This will include:

- increasing Financial Planning and Retirement (FP&R) open book assets by more than £50 billion by 2020 with more than 1 million new pension customers;
- implementing an integrated FP&R proposition with single customer view; and
- start-up, SME and Mid Market net lending growth (more than £6 billion in the plan period).

Transforming ways of working

The Group is making its biggest ever investment in people, increasing colleague training and development by 50 per cent to 4.4 million hours per annum and embracing new technology to drive better customer outcomes. The hard work, commitment and expertise of the Group's colleagues has enabled it to deliver to date and the Group will further invest in capabilities and agile working practices. The Group has already restructured the business and reorganised the leadership team to ensure effective implementation of the new strategy.

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

As part of a Group restructuring during 2017 the Consumer Finance division has now become part of Retail; the Group's UK wealth business, previously part of Retail, has been transferred to the Insurance division, now renamed Insurance and Wealth; the Group's International wealth business, previously part of Retail, has been transferred to the Commercial Banking division; and the Group's venture capital business, previously part of Commercial Banking, has been transferred to Other.

Following this restructuring, the Group's activities are now organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

Further information on the Group's segments is set out on pages 24 to 32 and in note 4 to the financial statements.

MATERIAL CONTRACTS

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

ENVIRONMENTAL MATTERS

A sustainable and responsible approach is integral to how the Group operates.

The Group needs to use scarce natural resources more sustainably, manage its environmental impacts and support its customers by financing opportunities created by the transition to a low carbon economy.

MANAGING ENVIRONMENTAL IMPACTS

Delivering the science-based carbon reduction and climate resilience targets set out in the Paris Agreement will have significant structural implications for the economy and the businesses and communities the Group serves. That is why the Group is evolving its Group-wide sustainability strategy.

This year, overall carbon emissions were 292,848 tonnes of CO_2e, a decrease of 14 per cent year-on-year and of 48 per cent against the 2009 baseline. This is mainly attributable to the reduction in consumption of gas and electricity, which make up the largest proportion of the Group's emissions, as a result of its extensive energy management programme. In 2017, the Group also reduced the CO_2e related to its business travel by promoting 'No Travel Week', encouraging travel alternatives and the successful roll out of 'WebEx', Group-wide.

CO_2E EMISSIONS

	Oct 16 - Sept 17	Oct 15 - Sept 16[1,2]	Oct 14 - Sept 15[1,2]
Total CO_2 e	**292,848**	340,382	395,543
Total Scope 1	**52,160**	53,026	58,851
Total Scope 2	**166,617**	202,414	239,709
Total Scope 3	**74,071**	84,943	96,983

1 Restated 2014/2015 and 2015/2016 emissions data to improve the accuracy of reporting, using actual data to replace estimates.

2 Restated all historic years to reflect improved methodology in assigning road travel between reporting scopes.

Emissions in tonnes CO_2 e in line with the GHG Protocol Corporate Standard (2004). The Group is in the process of transitioning to the revised Scope 2 guidance. Criteria used to measure and report Scope 1, 2, 3 emissions is provided in the Lloyds Banking Group Reporting Criteria statement available online at www.lloydsbankinggroup.com/responsible-business.

Scope 1 emissions include mobile and stationary combustion of fuel and operation of facilities.

Scope 2 emissions have been calculated using a location based methodology, as set out by the GHG Protocol.

Indicator is subject to Limited ISAE3000 (revised) assurance by Deloitte LLP for the 2017 Annual Responsible Business Reporting. Deloitte's 2017 assurance statement and the 2017 Reporting Criteria are available online at www.lloydsbankinggroup.com/rbdownloads

SUPPORTING THE LOW CARBON ECONOMY

The Group is helping more of its commercial clients to understand and manage their sustainability risks and the Group completes an environmental risk assessment at the start of every new client relationship. The Group is currently exploring ways to build sustainability considerations into its policies and risk management processes. The Group offers customers products and services that help them embrace sustainability. In 2016, the Group launched an innovative £1 billion Green Loan Initiative to incentivise commercial real estate to become more energy efficient and this year exceeded its target to help 2 million square feet of real estate.

At the end of 2017, the Group's UK team had financed renewable projects with a combined capacity of over 2.75GW (2016: 1.78GW) and internationally the Group's existing investments in renewables exceed 8.9GW (2016: 7.4GW). In 2017 Lloyds Bank played an important part in Macquarie's acquisition of the Green Investment Bank (now Green Investment Group), providing financing for a significant portfolio of operational offshore wind farms including Sheringham Shoal, Gwynt y Mor, Rhyl Flats and projects in construction, including Galloper and Rampion offshore wind farms. Together the projects have a total capacity of approximately 2.4GW, which is enough to power over 1.7 million homes and they will support a significant number of jobs across the UK through the supply chain and maintenance of the wind farms.

THE IMPACT OF CLIMATE RISK

The Group welcomes the recommendations of the Financial Stability Board Taskforce on Climate-related Financial Disclosures (TCFD) and has mapped its approach to them. The Group is developing a strategy and implementing processes to:

Assess the materiality of climate risk across its business
Identify and define a range of scenarios, including relevant physical and transition risk
Evaluate the business impacts
Identify potential responses to manage the risks and opportunities

The Group will address a number of these and will disclose further information on its work in this important area.

CLIMATE RELATED FINANCIAL DISCLOSURES

Strategy

In 2017, the Group reviewed how it integrates environmental sustainability into its strategy and risk management processes, taking advice from external advisors and working with all parts of the business to understand work already in plan and where it needs to do more. The Group is committed to supporting the transition to a low carbon economy through its financial products and services, including renewable energy services.

Governance of climate change

The Responsible Business Committee, a sub-committee of the Board, will take overall responsibility for the Group's climate-related impacts and risks from 2018. It is chaired by an Independent Director, Sara Weller, and meets regularly throughout the year. The Group has refocused its executive-level Responsible Business Management Committee to become its Sustainability Committee and will ensure that staff with operational responsibilities across the Group's key divisions are actively involved in the development and implementation of a comprehensive environmental sustainability strategy. Discussions involving these Committees and the Commercial Banking leadership team were held in 2017 to start to examine the strategic implications of environmental challenges, including climate change.

BUSINESS

Risk management

The Sustainability Committee will oversee the assessment of the Group's climate-related risks, escalating to the Responsible Business Committee and the Board Risk Committee as appropriate. The Group's divisions are each exposed to different levels of climate risk. For example, as a large home insurer, the Group is aware that global warming is projected to increase the risk of flooding and consequently weather-related insurance claims. It is important that the Group continues to work with its customers, industry peers and government to ensure this risk is minimised and mitigated to keep flood insurance affordable.

Metrics and targets

The Group is working to develop strategic commitments and targets in response to climate-related risks and opportunities, with different parts of the business feeding into this target setting process. This builds on its work to reduce the environmental impact of its own operations.

The target is to reduce the Group's overall CO_2e by 60 per cent by 2030 and 80 per cent by 2050, in line with the UK's emission reduction targets. This follows a science-based target setting methodology. As part of its Green Loan Initiative, the Group's target is to fund 5 million square feet of commercial real estate to become more energy efficient by 2020, the equivalent of five London Shards. The Group has set a new target to help provide power for 5 million homes through its investment in renewable energy by 2020.

The Group will also consider the supplementary industry specific recommendations for the financial sector.

PROPERTIES

At 31 December 2017, Lloyds Banking Group occupied 2,021 properties in the UK. Of these, 429 were held as freeholds and 1,592 as leasehold. The majority of these properties are retail branches, widely distributed throughout England, Scotland, Wales and Northern Ireland. Other buildings include the Lloyds Banking Group's head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations – London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 169 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis.

LEGAL ACTIONS AND REGULATORY MATTERS

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory reviews and investigations both in the UK and overseas. Set out below is a summary of the more significant matters.

PAYMENT PROTECTION INSURANCE (EXCLUDING MBNA)

The Group increased the provision for PPI costs by a further £1,300 million in 2017, of which £600 million was in the fourth quarter, bringing the total amount provided to £18,675 million. The remaining provision is consistent with an average of 11,000 complaints per week (previously 9,000) through to the industry deadline of August 2019, in line with the average experience over the last nine months.

The higher volume of complaints received has been driven by increased claims management company (CMC) marketing activity and the Financial Conduct Authority (FCA) advertising campaign.

At 31 December 2017, a provision of £2,438 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £1,470 million during the year to 31 December 2017.

SENSITIVITIES

The Group estimates that it has sold approximately 16 million PPI policies since 2000. These include policies that were not mis-sold and those that have been successfully claimed upon. Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 53 per cent of the policies sold since 2000.

The total amount provided for PPI represents the Group’s best estimate of the likely future cost. However a number of risks and uncertainties remain in particular with respect to future volumes. The cost could differ from the Group’s estimates and the assumptions underpinning them, and could result in a further provision being required. There is significant uncertainty around the impact of the regulatory changes, FCA media campaign and Claims Management Company and customer activity.

For every additional 1,000 reactive complaints per week above 11,000 on average through to the industry deadline of August 2019, the Group would expect an additional charge of £200 million.

PAYMENT PROTECTION INSURANCE (MBNA)

With regard to MBNA, as announced in December 2016, the Group's exposure is capped at £240 million already provided for, through an indemnity received from Bank of America.

OTHER PROVISIONS FOR LEGAL ACTIONS AND 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 other governmental authorities on a range of matters. The Group also receives complaints in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2017 the Group charged a further £865 million in respect of legal actions and other regulatory matters, the unutilised balance at 31 December 2017 was £1,292 million (31 December 2016: £1,339 million). The most significant items are as follows.

ARREARS HANDLING RELATED ACTIVITIES

The Group has provided an additional £245 million (bringing the total provided to date to £642 million), for the costs of identifying and rectifying certain arrears management fees and activities. Following a review of the Group's arrears handling activities, the Group has put in place a number of actions to improve further its handling of customers in these areas and has made good progress in reimbursing mortgage arrears fees to the 590,000 impacted customers.

PACKAGED BANK ACCOUNTS

In 2017 the Group provided an additional £245 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £750 million. A number of risks and uncertainties remain in particular with respect to future volumes.

CUSTOMER CLAIMS IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY

The Group continues to receive claims in Germany from customers relating to policies issued by Clerical Medical Investment Group Limited (subsequently renamed Scottish Widows Limited). The German industry-wide issue regarding notification of contractual 'cooling off' periods continued to lead to an increasing number of claims in 2016 and 2017. Up to 31 December 2016 the Group had provided a total of £639 million and no further amounts have been provided to 31 December 2017. The validity of the claims facing the Group depends 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 be known only once all relevant claims have been resolved.

HBOS READING – CUSTOMER REVIEW

The Group is undertaking a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Group in 2009. The Group has provided £100 million in the year to 31 December 2017 and is in the process of paying compensation to the victims of the fraud for economic losses as well as ex-gratia payments and awards for distress and inconvenience. The review is ongoing and at 12 February 2018, the Group had made offers to 57 customers, which represents more than 80 per cent of the customers in review.

INTERCHANGE FEES

With respect to multi-lateral interchange fees (MIFs), the Group is not directly involved in the ongoing investigations and litigation (as described below) which involve card schemes such as Visa and MasterCard. However, the Group is a member of Visa and MasterCard and other card schemes.

– The European Commission continues to pursue competition investigations against MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA.

– Litigation brought by retailers continues in the English Courts against both Visa and MasterCard.

Any ultimate impact on the Group of the above investigations and litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. As part of this transaction, the Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. The maximum amount of liability to which the Group may be subject under the LSA is capped at the cash consideration which was received by the Group at completion. Visa Inc may also have recourse to a general indemnity, previously in place under Visa Europe's Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR AND OTHER TRADING RATES

In July 2014, the Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the Swiss Competition Commission, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

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, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. Certain of the plaintiffs' claims, including those in connection with USD and JPY LIBOR, have been dismissed by the US Federal

Court for Southern District of New York, and decisions are awaited on the Group's motions to dismiss the Sterling LIBOR and BBSW claims. The decisions leading to the Group's dismissal from the USD LIBOR claims are subject to two appeals; the first took place on 25 September 2017 and a decision is expected in the first quarter of 2018, and the second is expected to take place in the first half of 2018. The decisions leading to the Group's dismissal from the JPY LIBOR claims are not presently subject to appeal.

Certain Group companies are also named as defendants in: (i) UK based claims; and (ii) in a Dutch class action, each raising LIBOR manipulation allegations. A number of the claims against the Group in relation to the alleged mis-sale of Interest Rate Hedging Products also include allegations of LIBOR manipulation.

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

UK SHAREHOLDER LITIGATION

In August 2014, the Group and a number of former directors were named as defendants in a claim by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. The defendants refute all claims made. A trial commenced in the English High Court on 18 October 2017 and is scheduled to conclude in the first quarter of 2018 with judgment to follow. It is currently not possible to determine the ultimate impact on the Group (if any).

FINANCIAL SERVICES COMPENSATION SCHEME

Following the default of a number of deposit takers in 2008, the Financial Services Compensation Scheme (FSCS) borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. In June 2017, the FSCS announced that following the sale of certain Bradford & Bingley mortgage assets, the principal balance outstanding on the HM Treasury loan was £4,678 million (31 December 2016: £15,655 million). Although it is anticipated that the substantial majority of this loan 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, including the Group, of the FSCS. The amount of future levies payable by the Group depends on a number of factors, principally, the amounts recovered by the FSCS from asset sales.

TAX AUTHORITIES

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 2013 HMRC informed the Group that their interpretation of the UK rules which allow 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 £650 million (including interest) and a reduction in the Group's deferred tax asset of approximately £350 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. There are a number of other open matters on which the Group is in discussion with HMRC (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc), none of which is expected to have a material impact on the financial position of the Group.

RESIDENTIAL MORTGAGE REPOSSESSIONS

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases concerning certain aspects of the Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA is actively engaged with the industry in relation to these considerations and has published Guidance on the treatment of customers with mortgage payment shortfalls. The Guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers' monthly mortgage instalments. The Group is now determining its detailed approach to implementation of the Guidance and will contact affected customers during 2018.

MORTGAGE ARREARS HANDLING ACTIVITIES

On 26 May 2016, the Group was informed that an enforcement team at the FCA had commenced an investigation in connection with the Group's mortgage arrears handling activities. This investigation is ongoing and it is currently not possible to make a reliable assessment of the liability, if any, that may result from the investigation.

CONTINGENT LIABILITIES RELATING TO OTHER LEGAL ACTIONS AND REGULATORY MATTERS

In addition, during the ordinary course of business the Group is subject to other complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, 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 at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed properly to assess the merits of the case, and no provisions are held in relation to such matters. In these circumstances, specific disclosure in relation to a contingent liability will be made where material. 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.

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COMPETITIVE ENVIRONMENT

The Group provides financial services to individual and business customers, predominantly in the UK but also overseas. The main business activities of the Group are retail and commercial banking and long-term savings, protection and investment.

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

The markets for UK financial services, and the other markets within which the Group operates, are competitive, and management expects such competition to continue or intensify in response to competitor behaviour, including non-traditional competitors, consumer demand, technological changes such as the growth of digital banking, and the impact of regulatory actions and other factors.

For more information see "*Risk Factors – Business and economic risks – The Group's businesses are conducted in competitive environments, with increased competition scrutiny, and the Group's financial performance depends upon management's ability to respond effectively to competitive pressures.*"

RECENT DEVELOPMENTS

On 8 March 2018 the Group announced that it was launching a share buyback programme to repurchase up to £1 billion of its outstanding ordinary shares, as previously announced on 21 February 2018.

The Group has entered into an agreement with UBS AG, London Branch ("UBS") to conduct the share buyback programme on its behalf and to make trading decisions under the programme independently of the Group. Under the terms of the programme, the maximum consideration is £1 billion. The programme commenced on 8 March 2018 and will end no later than 4 February 2019. The sole purpose of the programme is to reduce the outstanding ordinary share capital of the Group.

UBS will purchase the Group's ordinary shares as principal and sell them on to the Group in accordance with the terms of their engagement. The Group intends to cancel the shares that it purchases through the programme.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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Given the Group's UK focus, its prospects are closely linked to the strength of the UK economy
Despite near-term uncertainties about the future relationship with the EU, the UK economy is expected to remain resilient in 2018, growing at a similar pace to 2017. Longer term growth potential is still expected to be faster than the Eurozone and similar to the US
Interest rates are expected to remain low, with gradual rises beneficial to the Group's savings customers and the Group

OVERVIEW

As a UK focused financial services provider, the Group's prospects are closely aligned to the strength of and outlook for the UK economy. In the period following the decision to leave the EU, the UK economy has remained resilient. Growth has slowed only a little below its trend rate, unemployment has continued to fall to a 40-year low, and property prices have continued to rise slowly. In the absence of any sudden shocks to business or consumer confidence, this recent resilience is expected to continue in 2018 and the next few years. In common with many other countries, the biggest uncertainty for longer term growth is the degree to which productivity growth improves from its weak rate of the past decade.

OPPORTUNITIES

The economy's resilience bodes well for the Group and its customers. While interest rates are expected to increase only gradually, the Bank of England's first increase in Bank Rate in over 10 years has benefited savers, many of whom will have dealt with low rates for a prolonged period, and will support banking margins. In recent years, low interest rates and the Group's low risk approach have been reflected in low and falling levels of impairments against the Group's lending balances.

Looking ahead, impairments are expected to remain at benign levels at an industry level, with contributing factors including the slow pace of expected interest rate increases, unemployment remaining close to its current 40-year low, and the benefit of both continuing to support property prices. Meanwhile, business confidence has to date held up well in the face of global and domestic uncertainties. Manufacturers and exporters have been aided by sterling's depreciation since late 2015, and businesses generally are benefiting from low debt service costs.

CHALLENGES

Households' spending power has been squeezed over the past year as the rise in inflation to 3 per cent by the end of 2017 has outpaced growth in pay that has remained subdued in a broadly 2-2.5 per cent range over the year, partly reflecting weak productivity growth. While inflation is expected to slow, it is likely to trend towards 2 per cent only gradually through the next three year chapter of the Group's strategy, and whilst the Group expects wage growth to improve and end the spending power squeeze, it is uncertain how quickly this will happen. Meanwhile, the economy is more reliant than normal on business investment and exports to drive growth.

Business investment is likely to have been impacted by the uncertainty around the UK's future trading relationship with the EU but as negotiations progress and that relationship becomes clearer, investment spending should be supported. Operational impacts of the UK's exit from the EU present risks for some of the Group's customers' businesses, although the UK's continued competitive advantages in innovation and high value services, and the flexible labour market should enable the economy to prosper longer term in growing world markets.

OUTLOOK

Barring unexpected sudden shocks to consumer or business confidence, the near-term outlook for both the UK economy and the Group remains relatively benign. A tight labour market and gradual productivity improvements should over time underpin quickening wage growth, whilst inflation is expected to start falling through 2018, the combination gradually ending the squeeze on households' spending power. With unemployment remaining close to its current 40-year lows, Bank Rate is expected to continue to rise, but only slowly. House prices are expected to rise marginally, with the affordability impact of slightly higher interest rates offset by improving disposable incomes.

The Group is not immune to the challenges facing the near-term and medium-term economic outlook, but its UK focus means that the current benign conditions and resilience of the UK economy will be supportive to the Group's performance through the delivery of the next chapter of its strategy. Direct operational impacts from EU exit are also limited.

CRITICAL ACCOUNTING POLICIES

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

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

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group's IFRS reporting are discussed in note 54 to the financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS – 2017, 2016 AND 2015

SUMMARY

	2017 £m	2016 £m	2015 £m
Net interest income	10,912	9,274	11,318
Other income	23,325	30,337	11,832
Total income	34,237	39,611	23,150
Insurance claims	(15,578)	(22,344)	(5,729)
Total income, net of insurance claims	18,659	17,267	17,421
Operating expenses	(12,346)	(12,627)	(15,387)
Trading surplus	6,313	4,640	2,034
Impairment	(688)	(752)	(390)
Profit before tax	5,625	3,888	1,644
Tax expense	(1,728)	(1,724)	(688)
Profit for the year	3,897	2,164	956
Profit attributable to ordinary shareholders	3,392	1,651	466
Profit attributable to other equity holders[1]	415	412	394
Profit attributable to equity holders	3,807	2,063	860
Profit attributable to non-controlling interests	90	101	96
Profit for the year	3,897	2,164	956

1 The profit after tax attributable to other equity holders of £415 million (2016: £412 million; 2015: £394 million) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £102 million (2016: £91 million; 2015: £80 million).

2017 COMPARED WITH 2016

During the year ended 31 December 2017, the Group recorded a profit before tax of £5,625 million compared with a profit before tax in 2016 of £3,888 million.

Total income decreased by £5,374 million, or 14 per cent, to £34,237 million in 2017 compared with £39,611 million in 2016, comprising a £7,012 million decrease in other income only partly offset by an increase of £1,638 million in net interest income.

Net interest income was £10,912 million in 2017; an increase of £1,638 million, or 18 per cent compared to £9,274 million in 2016. There was a positive impact of £622 million in 2017 from a decrease in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group, reflecting different levels of investment returns on the assets held by the OEICs; the change in population of consolidated OEICs in 2017 compared to 2016 did not have a significant impact. After adjusting for this, net interest income was £1,016 million, or 9 per cent higher. Average interest-earning assets fell as a result of decreases in average UK mortgage balances, lending to global corporates and in the portfolio of assets which are outside of the Group's risk appetite, more than offsetting the impact of the acquisition of MBNA. Net interest margin improved, excluding the impact of amounts payable to OEIC unitholders, as a result of lower deposit and wholesale funding costs and a positive impact from the acquisition of MBNA, more than offsetting continued pressure on asset margins.

Other income was £7,012 million, or 23 per cent, lower at £23,325 million in 2017 compared to £30,337 million in 2016. Fee and commission income was £80 million or 3 per cent, lower at £2,965 million compared to £3,045 million in 2016 as increased levels of card fees, reflecting both the acquisition of MBNA and higher levels of card usage, were more than offset by lower current account fees, reflecting reduced volumes of added-value accounts and changes in pricing structure, and lower levels of other fees receivable. Fee and commission expense increased by £26 million, or 2 per cent, to £1,382 million compared with £1,356 million in 2016. Net trading income decreased by £6,728 million, or 36 per cent, to £11,817 million in 2017 compared to £18,545 million in 2016; this decrease reflected a reduction of £6,630 million in gains on policyholder investments held within the insurance business as a result of market conditions over 2017 relative to those in 2016. Insurance premium income was £138 million, or 2 per cent, lower at £7,930 million in 2017 compared with £8,068 million in 2016; there was a decrease of £23 million in life insurance premiums and a £115 million decrease in general insurance premiums. The decrease in life insurance premiums reflects the fact that good growth in corporate pensions business has been offset by a lower level of bulk annuity deals, compared to the activity in 2016. General insurance premiums decreased as a result of market conditions and the continued run-off of closed books. Other operating income was £40 million, or 2 per cent, lower at £1,995 million in 2017 compared to £2,035 million in 2016.

Insurance claims expense was £6,766 million, or 30 per cent, lower at £15,578 million in 2017 compared to £22,344 million in 2016. The insurance claims expense in respect of life and pensions business was £6,737 million lower at £15,241 million in 2017 compared to £21,978 million in 2016; this decrease was matched by a similar reduction in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £29 million or 8 per cent, lower at £337 million in 2017 compared to £366 million in 2016 as a result of the continued run-down of closed books and relatively benign weather conditions in 2017 compared to 2016.

Operating expenses decreased by £281 million, or 2 per cent to £12,346 million in 2017 compared with £12,627 million in 2016; the main reason for this decrease being the £209 million reduction in charges for redress payments to customers in respect of PPI and other conduct related matters from £2,374 million in 2016 to £2,165 million in 2017. Excluding these charges from both years, operating expenses were £72 million, or 1 per cent, lower at £10,181 million in 2017 compared to £10,253 million in 2016 as operating expenses of £172 million arising in MBNA since acquisition have been more than offset by the impact of underlying cost reductions. Staff costs were £207 million, or 4 per cent, lower at £4,610 million in 2017 compared with £4,817 million in 2016; increases in pension charges being more than offset by headcount related reductions in salaries and lower levels of severance costs. Premises and equipment costs were £58 million or 9 per cent, higher at £730 million in 2017 compared with £672 million in 2016. Other expenses were £79 million, or 3 per cent, higher at £2,463 million in 2017 compared with £2,384 million in 2016. Depreciation and amortisation costs were £10 million lower at £2,370 million in 2017 compared to £2,380 million in 2016, as increased charges in respect of property, plant and equipment were more than offset by reduced charges relating to intangible assets.

Impairment losses decreased by £64 million, or 9 per cent, to £688 million in 2017 compared with £752 million in 2016; this reflects the fact that in 2016 there was an impairment charge of £173 million in respect of certain equity investments in the Group's available-for-sale portfolio which was not repeated in 2017. Impairment losses in respect of loans and advances to customers were £105 million, or 18 per cent, higher at £697 million in 2017 compared with £592 million in 2016; this includes a charge of £118 million in the MBNA business since acquisition and there were lower levels of releases and write-backs than in 2016. There was a credit of £9 million in respect of undrawn commitments in 2017, compared to a credit of £13 million in 2016.

In 2017, the Group recorded a tax expense of £1,728 million compared to a tax expense of £1,724 million in 2016, an effective tax rate of 31 per cent, compared to the standard UK corporation tax rate of 19.25 per cent, principally as a result of the banking surcharge and restrictions on the deductibility of conduct provisions.

Total assets were £5,684 million, or 1 per cent, lower at £812,109 million at 31 December 2017 compared to £817,793 million at 31 December 2016. Trading and other financial assets at fair value through profit or loss were £11,704 million, or 8 per cent, higher at £162,878 million compared to £151,174 million at 31 December 2016 due to the inclusion of a number of investments in OEICs which were de-consolidated during the year. However, loans and advances to banks were £20,291 million, or 75 per cent, lower at £6,611 million compared to £26,902 million at 31 December 2016 following the de-consolidation of these OEICs. Derivative assets were £10,304 million, or 29 per cent, lower at £25,834 million at 31 December 2017 compared to £36,138 million at 31 December 2016, largely as a result of exchange rate movements. Loans and advances to customers were £14,540 million, or 3 per cent, higher at £472,498 million at 31 December 2017 compared to £457,958 million at 31 December 2016; the addition of £8,144 million of lending following the acquisition of MBNA and an £8,528 million increase in reverse repurchase agreement balances together with the impact of the reacquisition of a portfolio of mortgages from TSB and growth in consumer finance and SME lending have more than offset reductions in the larger corporate sector, as the Group focuses on optimising capital and returns, and in closed mortgage books. Available-for-sale financial assets were £14,426 million, or 26 per cent, lower at £42,098 million at 31 December 2017 compared to £56,524 million at 31 December 2016 reflecting reductions in the Group's holdings of UK government securities.

Total liabilities were £6,362 million, or 1 per cent, lower at £762,966 million at 31 December 2017 compared to £769,328 million at 31 December 2016. Deposits from banks were £13,420 million, or 82 per cent, higher at £29,804 million at 31 December 2017 compared to £16,384 million at 31 December 2016 as a result of an increase of £15,896 million in repurchase agreements. Customer deposits were £2,664 million, or 1 per cent, higher at £418,124 million compared to £415,460 million at 31 December 2016 as reductions in non-relationship deposit balances were more than offset by strong inflows from Commercial clients. Derivative liabilities were £8,800 million, or 25 per cent, lower at £26,124 million at 31 December 2017 compared to £34,924 million at 31 December 2016, largely as a result of exchange rate movements. Debt securities in issue were £3,864 million, or 5 per cent, lower at £72,450 million at 31 December 2017 compared to £76,314 million at 31 December 2016 following maturities of some tranches of securitisation notes and covered bonds. Other liabilities were £8,463 million, or 29 per cent, lower at £20,730 million at 31 December 2017 compared to £29,193 million at 31 December 2016 reflecting the deconsolidation of a number of OEICs. Subordinated liabilities were £1,909 million, or 10 per cent, lower at £17,922 million at 31 December 2017 compared to £19,831 million at 31 December 2016 reflecting redemptions in the year.

Total equity was £678 million, or 1 per cent, higher at £49,143 million at 31 December 2017 compared to £48,465 million at 31 December 2016 as retained profits for the year have more than offset the Group's dividend payments, distributions on its AT1 securities and other reserve movements.

The Group has strengthened its capital position, with a common equity tier 1 ratio of 14.1 per cent (31 December 2016: 13.4 per cent), largely driven by the increase in equity, offset in part by the increase in the deduction for goodwill and other intangible assets following the acquisition of MBNA, and a reduction in risk-weighted assets. The total capital ratio was unchanged at 21.2 per cent.

Risk-weighted assets reduced by £4,527 million, or 2 per cent, to £210,919 million at 31 December 2017 compared to £215,446 million at 31 December 2016, largely relating to updates made to both mortgage and unsecured retail Internal Ratings Based (IRB) models, continued active portfolio management, foreign exchange movements, disposals and capital efficient securitisation activity, partly offset by targeted growth in key customer segments and the acquisition of MBNA.

The Group's liquidity surplus exceeds the regulatory minimum and internal risk appetite with a Liquidity Coverage Ratio of 127 per cent based on EU Delegated Act at 31 December 2017. Wholesale funding reduced by 9 per cent to £101 billion compared with £111 billion at 31 December 2016. In addition, the Group made use of central bank funding schemes and by the end of 2017 the Group had fully utilised its £20 billion capacity from the Bank of England's Term Funding Scheme.

The Group has recommended a final ordinary dividend of 2.05 pence per share. This is in addition to the interim ordinary dividend of 1.0 pence per share that was paid in September 2017. The total ordinary dividend per share for 2017 of 3.05 pence per share has increased by 20 per cent, from 2.55 pence in 2016.

The Group continues to give due consideration at each year end to the return of any surplus capital and for 2017, intends to implement a share buyback of up to £1 billion. This represents the return of capital over and above the Board's view of the current level of capital required to grow the business, meet regulatory requirements and cover uncertainties. The share buyback programme will commence in March 2018 and is expected to be completed during the next twelve months.

2016 COMPARED WITH 2015

During the year ended 31 December 2016, the Group recorded a profit before tax of £3,888 million compared with a profit before tax in 2015 of £1,644 million. The result in 2016 included provisions in respect of redress to customers (together with the related administrative costs) associated with both past sales of Payment Protection Insurance and other matters of £2,435 million (of which £2,374 million is charged within operating expenses and £61 million against income) compared to a charge of £4,837 million in the year ended 31 December 2015. Excluding these charges from both years, profit before tax was £158 million, or 2 per cent, lower at £6,323 million in the year ended 31 December 2016 compared to £6,481 million in the previous year. The comparison of results for 2016 to 2015 was also impacted by the sale of TSB Banking Group plc (TSB), which ceased to be consolidated in March 2015, with the sale of the Group’s remaining holding becoming unconditional on 30 June 2015. The Group recognised a net loss of £660 million in 2015, relating to both the disposal of its shareholding and commitments under agreements entered into with TSB. After taking this item into account there was a reduction in profit before tax of £818 million.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Total income increased by £16,461 million, or 71 per cent, to £39,611 million in 2016 compared with £23,150 million in 2015, comprising an £18,505 million increase in other income partly offset by a decrease of £2,044 million in net interest income.

Net interest income was £9,274 million in 2016; a decrease of £2,044 million, or 18 per cent compared to £11,318 million in 2015. There was a negative impact of £1,813 million in 2016 from an increase in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group, reflecting different levels of investment returns on the assets held by the OEICs; the change in population of consolidated OEICs in 2016 compared to 2015 did not have a significant impact. After adjusting for this, net interest income was £231 million, or 2 per cent lower, of which £592 million related to TSB which was sold in 2015. Average interest-earning assets fell as a result of decreases in average UK mortgage balances and in the portfolio of assets which are outside of the Group's risk appetite, as well as a reduction of some £5 billion as result of the sale of TSB, more than offsetting growth in small business and unsecured personal lending. Net interest margin improved, excluding the impact of amounts payable to OEIC unitholders.

Other income was £18,505 million higher at £30,337 million in 2016 compared to £11,832 million in 2015. Fee and commission income was £207 million, or 6 per cent, lower at £3,045 million compared to £3,252 million in 2015. Fee and commission expense decreased by £86 million, or 6 per cent, to £1,356 million compared with £1,442 million in 2015. The decrease in net fee and commission income largely reflects lower levels of current account and credit and debit card fees as well as reduced income from commercial banking activities. Net trading income increased by £14,831 million to £18,545 million in 2016 compared to £3,714 million in 2015; this increase reflected an improvement of £14,797 million in gains on policyholder investments held within the insurance business as a result of market conditions over 2016 relative to those in 2015. Insurance premium income was £3,276 million, or 68 per cent, higher at £8,068 million in 2016 compared with £4,792 million in 2015; there was an increase of £3,289 million in life insurance premiums and a £13 million decrease in general insurance premiums. Premium income in 2015 had been reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group; excluding this item life insurance premium income was £1,330 million, or 23 per cent, higher at £7,210 million in 2016 compared to £5,880 million in 2015, principally reflecting growth in bulk annuity business. Other operating income was £519 million higher at £2,035 million in 2016 compared to £1,516 million in 2015 as a gain of £484 million on sale of the Group's investment in VISA Europe and an improvement in income from the value of in-force insurance business more than offset a loss on redemption of the Group's Enhanced Capital Notes.

Insurance claims expense was £16,615 million higher at £22,344 million in 2016 compared to £5,729 million in 2015. The insurance claims expense in respect of life and pensions business was £16,619 million higher at £21,978 million in 2016 compared to £5,359 million in 2015; this increase was matched by a similar improvement in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £4 million or 1 per cent, lower at £366 million in 2016 compared to £370 million in 2015.

Operating expenses decreased by £2,760 million, or 18 per cent to £12,627 million in 2016 compared with £15,387 million in 2015; the main reason for the decrease being the £2,463 million reduction in charges for redress payments to customers in respect of PPI and other conduct related matters from £4,837 million in 2015 to £2,374 million in 2016 and a charge of £665 million in 2015 in relation to the disposal of TSB. Excluding these items from both years, operating expenses were £368 million, or 4 per cent, higher at £10,253 million in 2016 compared to £9,885 million in 2015. Staff costs were £140 million, or 3 per cent, higher at £4,817 million in 2016 compared with £4,677 million in 2015; although annual pay rises have been more than offset by the impact of headcount reductions resulting from the sale of TSB and the Group's rationalisation programmes, there has been an increase in severance costs in relation to restructuring initiatives. Premises and equipment costs were £43 million or 6 per cent, lower at £672 million in 2016 compared with £715 million in 2015. Other expenses, excluding the charge relating to the TSB disposal, were £3 million higher at £2,384 million in 2016 compared with £2,381 million in 2015. Depreciation and amortisation costs were £268 million, or 13 per cent, higher at £2,380 million in 2016 compared to £2,112 million in 2015, in line with increased asset balances, particularly operating lease assets and capitalised software.

Impairment losses increased by £362 million, or 93 per cent, to £752 million in 2016 compared with £390 million in 2015. Impairment losses in respect of loans and advances to customers were £149 million, or 34 per cent, higher at £592 million in 2016 compared with £443 million in 2015; this reflects a lower level of releases and recoveries rather than a deterioration in quality of the underlying portfolio. There was a credit of £13 million in respect of undrawn commitments in 2016, compared to a credit of £55 million in 2015. In addition there was an impairment charge of £173 million in respect of certain equity investments in the Group's available-for-sale portfolio.

In 2016, the Group recorded a tax expense of £1,724 million compared to a tax expense of £688 million in 2015, an effective tax rate of 44 per cent, compared to the standard UK corporation tax rate of 20 per cent, principally as a result of the banking surcharge, restrictions on the deductibility of conduct provisions and the negative impact on the net deferred tax asset of both the change in corporation tax rate and the expected utilisation by the life business.

Total assets were £11,105 million, or 1 per cent, higher at £817,793 million at 31 December 2016 compared to £806,688 million at 31 December 2015. Cash and balances at central banks were £10,965 million, or 19 per cent, lower at £47,452 million compared to £58,417 million at 31 December 2015, reflecting fewer opportunities for the favourable placement of funds and trading and other assets at fair value through profit or loss were £10,638 million, or 8 per cent, higher at £151,174 million compared to £140,536 million at 31 December 2015, principally due to increases in the long-term insurance and investment funds. Loans and advances to customers were £2,783 million, or 1 per cent, higher at £457,958 million at 31 December 2016 compared to £455,175 million at 31 December 2015; the continued reduction in the portfolio of assets which are outside of the Group's risk appetite and lower UK mortgage balances, as the Group concentrates on protecting margin in the current market, were more than offset by an £8,304 million increase in reverse repurchase agreement balances together with growth in SME lending and the UK consumer finance business. Available-for-sale financial assets were £23,492 million, or 71 per cent, higher at £56,524 million compared to £33,032 million at 31 December 2015; during 2016, the Group reviewed its holding of government securities classified as held-to-maturity (£19,808 million at 31 December 2015) in light of the prevailing low interest rate environment and they have been reclassified as available-for-sale. Total liabilities were £9,620 million, or 1 per cent, higher at £769,328 million at 31 December 2016 compared to £759,708 million at 31 December 2015. Debt securities in issue were £5,742 million, or 7 per cent, lower at £76,314 million compared to £82,056 million at 31 December 2015, reflecting reduced funding requirements; however Insurance and investment contract liabilities were, together, £11,431 million, or 11 per cent, higher at £114,502 million, compared to £103,071 million at 31 December 2015, in line with the increase in investment assets. Subordinated liabilities were

£3,481 million or 15 per cent, lower at £19,831 million compared to £23,312 million at 31 December 2015 as a result of redemptions during the year, including the Group’s Enhanced Capital Notes. Total equity was £1,485 million, or 3 per cent, higher at £48,465 million at 31 December 2016 compared to £46,980 million at 31 December 2015; this reflected positive revaluation movements in the available-for-sale and cash flow hedging reserves.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group strengthened its capital position, with a common equity tier 1 ratio of 13.4 per cent (31 December 2015: 12.8 per cent), largely driven by the increase in profits and a reduction in risk-weighted assets. The total capital ratio reduced to 21.2 per cent (31 December 2015: 21.5 per cent) primarily reflecting managed reductions in Tier 2 loan stock, largely through calls and redemptions, offset by the increase in common equity tier 1 capital and the reduction in risk-weighted assets.

Risk-weighted assets reduced by £7,399 million, or 3 per cent, to £215,446 million at 31 December 2016 compared to £222,845 million at 31 December 2015, largely relating to active portfolio management, disposals, an improvement in credit quality and capital efficient securitisation activity, partially offset by model updates related to UK mortgage portfolios and foreign exchange movements reflecting the depreciation in Sterling.

The Group's liquidity position remained good, with liquidity coverage ratio (LCR) eligible assets of £121 billion. LCR eligible assets represented over 8 times the Group's money-market funding with a maturity of less than one year and were in excess of total wholesale funding at 31 December 2016. The Group's LCR ratio continued to exceed regulatory requirements.

The Group recommended a final ordinary dividend of 1.70 pence per share, together with a capital distribution in the form of a special dividend of 0.5 pence per share. This was in addition to the interim ordinary dividend of 0.85 pence per share that was paid in September 2016.

The total ordinary dividend per share for 2016 of 2.55 pence per share had increased by 13 per cent, from 2.25 pence in 2015.

NET INTEREST INCOME

	2017	2016	2015
Net interest income £m	10,912	9,274	11,318
Average interest-earning assets £m	585,374	600,435	614,917
Average rates:			
Gross yield on interest-earning assets %[1]	2.73	2.77	2.86
Interest spread %[2]	1.67	1.33	1.67
Net interest margin %[3]	1.86	1.54	1.84

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

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

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

2017 COMPARED WITH 2016

Net interest income was £10,912 million in 2017, an increase of £1,638 million, or 18 per cent, compared to £9,274 million in 2016. Net interest income in 2017 includes a charge of £1,435 million in respect of amounts attributable to third party investors in respect of its consolidated Open-Ended Investment Companies (OEICs) compared to a charge in 2016 of £2,057 million as a result of positive market movements in the year, with gains ranging from (1.0) per cent to 37.2 per cent in UK and global equity markets as well as in fixed income indices. The change in population of consolidated OEICs in 2017 compared to 2016 did not have a significant impact on this figure, contributing a net decrease of £65 million attributable to third party investors. After adjusting for the amounts payable to unitholders, net interest income was £1,016 million, or 9 per cent, higher at £12,347 million in 2017 compared to £11,331 million in 2016.

Average interest-earning assets were £15,061 million, or 3 per cent, lower at £585,374 million in 2017 compared to £600,435 million in 2016. The decrease reflected the impact of reductions in closed mortgage books, lending to global corporates and in the portfolio of assets which are outside of the Group’s risk appetite, more than offsetting the impact of the acquisition of MBNA.

The net interest margin was 32 basis points higher at 1.86 per cent in 2017 compared to 1.54 per cent in 2016, and adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 22 basis points higher at 2.11 per cent in 2017 compared to 1.89 per cent in 2016. The improvement in net interest margin reflected lower deposit and wholesale funding costs and a positive impact from the acquisition of MBNA, more than offsetting continued pressure on asset margins. Margins in Retail improved as a result of deposit repricing in the first quarter of 2017 and the positive impact of the acquisition of MBNA. Margins on relationship lending and similar interest-earning assets in Commercial Banking also improved as a result of the lower funding costs.

2016 COMPARED WITH 2015

Net interest income was £9,274 million in 2016, a decrease of £2,044 million, or 18 per cent, compared to £11,318 million in 2015. Net interest income in 2016 includes a charge of £2,057 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a charge in 2015 of £244 million. The increase reflects more favourable market conditions; the change in population of consolidated OEICs in 2016 compared to 2015 did not have a significant impact. After adjusting for the amounts payable to unitholders, net interest income was £231 million, or 2 per cent, lower at £11,331 million in 2016 compared to £11,562 million in 2015.

Average interest-earning assets were £14,482 million, or 2 per cent, lower at £600,435 million in 2016 compared to £614,917 million in 2015. The reduction reflected the impact of the sale of TSB part-way through 2015, the continuing run-off of assets which are outside of the Group’s risk appetite and a reduction in UK mortgage balances, reflecting the focus on protecting margins, partly offset by increased SME lending and unsecured personal lending.

The net interest margin was 30 basis points lower at 1.54 per cent in 2016 compared to 1.84 per cent in 2015, however adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 1 basis point higher at 1.89 per cent in 2016 compared to 1.88 per cent in 2015. Margins in Retail fell only slightly despite the challenges of the continuing low interest rate environment; due to the focus on high quality, lower margin business, with the margin also impacted by lower Euribor and planned reductions in deposits. Margins on relationship lending and similar interest-earning assets in Commercial Banking grew, supported by high quality deposit growth, disciplined deposit pricing and reduced funding costs.

OTHER INCOME

	2017 £m	2016 £m	2015 £m
Fee and commission income:			
Current account fees	712	752	804
Credit and debit card fees	953	875	918
Other	1,300	1,418	1,530
	2,965	3,045	3,252
Fee and commission expense	(1,382)	(1,356)	(1,442)
Net fee and commission income	1,583	1,689	1,810
Net trading income	11,817	18,545	3,714
Insurance premium income	7,930	8,068	4,792
Gains on sale of available-for-sale financial assets	446	575	51
Liability management	(14)	(598)	(28)
Other	1,563	2,058	1,493
Other operating income	1,995	2,035	1,516
Total other income	23,325	30,337	11,832

2017 COMPARED WITH 2016

Other income was £7,012 million, or 23 per cent, lower at £23,325 million in 2017 compared to £30,337 million in 2016.

Fee and commission income was £80 million, or 3 per cent, lower at £2,965 million in 2017 compared with £3,045 million in 2016. Current account fees were £40 million, or 5 per cent, lower at £712 million in 2017 compared to £752 million in 2016, due to lower volumes of added-value accounts and changes in pricing structure. An increase of £78 million, or 9 per cent, in credit and debit card fees from £875 million in 2016 to £953 million in 2017 resulted from the acquisition of MBNA and higher levels of card usage. Other fees and commissions receivable were £118 million, or 8 per cent, lower at £1,300 million in 2017 compared with £1,418 million in 2016.

Fee and commission expense was £26 million, or 2 per cent, higher at £1,382 million in 2017 compared to £1,356 million in 2016 as increased fees payable in card services, in part reflecting the acquisition of MBNA, have more than offset reductions on other fees payable.

Net trading income was £6,728 million, or 36 per cent, lower at £11,817 million in 2017 compared with £18,545 million in 2016. Net trading income within the insurance businesses was £6,630 million, or 38 per cent, lower at £10,941 million in 2017 compared to £17,571 million in 2016, which reflects reduced market gains over 2017 compared to 2016 in both debt security and equity investments. Net trading income within the Group’s banking activities was £98 million, or 10 per cent, lower at £876 million in 2017 compared to £974 million in 2016, reflecting the change in fair value of interest rate derivatives and foreign exchange contracts in the banking book not mitigated through hedge accounting.

Insurance premium income was £7,930 million in 2017 compared with £8,068 million in 2016; a decrease of £138 million, or 2 per cent. Earned premiums in respect of the Group's long-term life and pensions business were £23 million lower at £7,187 million in 2017 compared to £7,210 million in 2016 reflecting the fact that good growth in corporate pensions business has been offset by a lower level of bulk annuity deals, compared to the activity in 2016. General insurance earned premiums were £115 million, or 13 per cent, lower at £743 million in 2017 compared with £858 million in 2016 as a result of market conditions and the continued run-off of closed books.

Other operating income was £40 million, or 2 per cent, lower at £1,995 million in 2017 compared to £2,035 million in 2016. In 2016 there was a loss of £721 million arising on the Group's tender offers and redemptions in respect of its Enhanced Capital Notes which completed in March 2016; in 2017 there has been a reduction of £637 million in the movement in value of in-force business from a gain of £472 million in the year ended 31 December 2016 to a charge of £165 million in 2017. The reduction in the movement in value of in-force business reflected the negative impact of assumption changes and experience variances. Gains on sales of available-for-sale financial assets in 2017 included a gain of £146 million on the sale of the Group's investment in Vocalink and £274 million (2016: £112 million) from the sale of UK government securities; 2016 included a gain of £484 million on sale of the Group's investment in VISA Europe.

2016 COMPARED WITH 2015

Other income was £18,505 million higher at £30,337 million in 2016 compared to £11,832 million in 2015.

Fee and commission income was £207 million, or 6 per cent, lower at £3,045 million in 2016 compared with £3,252 million in 2015. Current account fees were £52 million, or 6 per cent, lower at £752 million in 2016 compared to £804 million in 2015, due to the disposal of TSB part-way through 2015 and lower levels of added-value account fees as a result of changing customer preferences. A decrease of £43 million, or 5 per cent, in credit and debit card fees from £918 million in 2015 to £875 million in 2016 resulted from reduced interchange income due to a market-wide cap on fees. Other fees and commissions receivable were £112 million, or 7 per cent lower at £1,418 million in 2016 compared with £1,530 million in 2015 again reflecting the disposal of TSB and reduced income in the Insurance and Commercial divisions and as the portfolio of assets which are outside of the Group's risk appetite continues to run down.

Fee and commission expense was £86 million, or 6 per cent, lower at £1,356 million in 2016 compared to £1,442 million in 2015 in part due to the disposal of TSB during 2015 but also reflecting reduced activity in the mortgage market and lower fees payable following the changes in interchange regulation.

Net trading income was £14,831 million higher at £18,545 million in 2016 compared with £3,714 million in 2015. Net trading income within the insurance businesses was £14,797 million higher at £17,571 million in 2016 compared to £2,774 million in 2015, which reflects higher levels of returns on policyholder investments as a result of more favourable market conditions over 2016. However this increase, along with the increase in long-term insurance premium income, was largely offset by the increase in insurance claims expense and the £1,813 million increase in the amounts payable to unit holders in those Open-Ended Investment Companies consolidated into the Group's results within net interest income. Net trading income within the Group's banking activities was £34 million, or 4 per cent, higher at £974 million in 2016 compared to £940 million in 2015.

Insurance premium income was £8,068 million in 2016 compared with £4,792 million in 2015; an increase of £3,276 million, or 68 per cent. Premium income in 2015 had been reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group. Excluding this item earned premiums in respect of the Group's long-term life and pensions business were £1,330 million, or 23 per cent, higher at £7,210 million in 2016 compared to £5,880 million in 2015 reflecting significant new bulk annuities business, more than offsetting reductions in protection and corporate pensions business. General insurance earned premiums were little changed, £13 million, or 1 per cent, lower at £858 million in 2016 compared with £871 million in 2015 as a result of the continuing run-off of closed business.

Other operating income was £519 million higher at £2,035 million in 2016 compared to £1,516 million in 2015 despite a net loss of £721 million arising on the Group's tender offers and redemptions in respect of its Enhanced Capital Notes which completed in March 2016. Excluding this item, other operating income was £1,240 million, or 82 per cent, higher at £2,756 million in 2016 compared to £1,516 million in 2015; this reflected a £634 million improvement in the movement in value of in-force insurance business, reflecting business growth and positive economic variance, and a £524 million increase in gains on disposal of available-for-sale financial assets, from £51 million in 2015 to £575 million in 2016, of which £484 million related to the sale of the Group's investment in Visa Europe.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OPERATING EXPENSES

	2017 £m	2016 £m	2015 £m
Administrative expenses:			
Staff:			
Salaries	2,679	2,750	2,808
Performance-based compensation	473	475	409
Social security costs	361	363	349
Pensions and other post-retirement benefit schemes	625	555	548
Restructuring costs	24	241	104
Other staff costs	448	433	459
	4,610	4,817	4,677
Premises and equipment:			
Rent and rates	365	365	368
Repairs and maintenance	231	187	173
Other	134	120	174
	730	672	715
Other expenses:			
Communications and data processing	882	848	893
Advertising and promotion	208	198	253
Professional fees	328	265	262
UK bank levy	231	200	270
TSB disposal	–	–	665
Other	814	873	703
	2,463	2,384	3,046
Depreciation and amortisation:			
Depreciation of tangible fixed assets	1,944	1,761	1,534
Amortisation of acquired value of in-force non-participating investment contracts	34	37	41
Amortisation of other intangible assets	392	582	537
	2,370	2,380	2,112
Goodwill impairment	8	–	–
Total operating expenses, excluding regulatory provisions	10,181	10,253	10,550
Regulatory provisions:			
Payment protection insurance provision	1,300	1,350	4,000
Other regulatory provisions[1]	865	1,024	837
	2,165	2,374	4,837
Total operating expenses	12,346	12,627	15,387
Cost:income ratio (%)[2]	66.2	73.1	88.3

1 In 2016, regulatory provisions of £61 million (2017: £nil; 2015: £nil) were charged against income.

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

2017 COMPARED WITH 2016

Operating expenses decreased by £281 million, or 2 per cent, to £12,346 million in 2017 compared with £12,627 million in 2016. This decrease principally reflects the fact that 2017 includes a regulatory provisions charge of £2,165 million, which was £209 million, or 9 per cent, lower than the charge of £2,374 million in 2016.

Staff costs were £207 million, or 4 per cent, lower in 2017 at £4,610 million compared to £4,817 million in 2016, reflecting, in particular, the impact of reduced headcount. On a full-time equivalent basis, the Group had 67,905 employees at the end of 2017, a reduction of 2,528 from 70,433 employees at 31 December 2016; and this represents an underlying reduction of 4,231 employees offset by an increase of 1,703 employees as a result of the acquisition of MBNA. Salaries were £71 million, or 3 per cent, lower at £2,679 million in 2017 compared with £2,750 million in 2016. Pension costs were £70 million, or 13 per cent, higher at £625 million in 2017 compared to £555 million in 2016; social security costs were £2 million, or 1 per cent, lower at £361 million in 2017 compared with £363 million in 2016; and other staff costs were £15 million, or 3 per cent, higher at £448 million in 2017 compared with £433 million in 2016.

Premises and equipment costs were £58 million, or 9 per cent, higher at £730 million in 2017 compared to £672 million in 2016. Rent and rates were unchanged at £365 million; repairs and maintenance costs were £44 million, or 24 per cent, higher at £231 million in 2017 compared to £187 million in 2016, as a result of charges relating to property rationalisation, and other premises and equipment costs increased by £14 million, or 12 per cent, from £120 million in 2016 to £134 million in 2017.

Other expenses, excluding the regulatory provisions charges, were 79 million, or 3 per cent, higher at £2,463 million in 2017 compared with £2,384 million in 2016. Communications and data processing costs were £34 million, or 4 per cent, higher at £882 million in 2017 compared with

£848 million in 2016 as a result of the acquisition of MBNA and project costs; professional fees were £63 million, or 24 per cent, higher at £328 million in 2017 compared to £265 million in 2016 as a result of costs in relation to regulatory developments such as ring-fencing; and advertising and promotion costs were £10 million, or 5 per cent, higher at £208 million in 2017 compared with £198 million in 2016, in part reflecting the acquisition of MBNA. The cost of the Bank levy was £31 million, or 16 per cent, higher at £231 million in 2017 compared to £200 million in 2016. Other costs were £59 million, or 7 per cent, lower at £814 million in 2017 compared with £873 million in 2016.

Depreciation and amortisation costs were £10 million lower at £2,370 million in 2017 compared with £2,380 million in 2016. Charges for the depreciation of tangible fixed assets were £183 million, or 10 per cent, higher at £1,944 million in 2017 compared to £1,761 million in 2016, in line with increased operating lease asset balances. The charge for the amortisation of intangible assets was £190 million, or 33 per cent, lower at £392 million in 2017 compared to £582 million in 2016, reflecting the fact that the core deposit intangible arising from the HBOS acquisition became fully amortised in the early part of 2017, only partly offset by charges relating to the purchased credit card receivable established on the MBNA acquisition and to software.

The Group incurred a regulatory provisions charge in operating expenses of £2,165 million in 2017 compared to £2,374 million in 2016 (in addition there was £61 million in the year ended 31 December 2016 which was charged against income) of which £1,300 million (2016: £1,350 million) related to payment protection insurance.

2016 COMPARED WITH 2015

Operating expenses decreased by £2,760 million, or 18 per cent, to £12,627 million in 2016 compared with £15,387 million in 2015. This decrease principally reflects the fact that 2016 includes a regulatory provisions charge of £2,374 million, which was £2,463 million, or 51 per cent, lower than the charge of £4,837 million in 2015.

Staff costs were £140 million, or 3 per cent, higher in 2016 at £4,817 million compared to £4,677 million in 2015, reflecting, in particular, increased expenditure in relation to the Group’s restructuring programmes. Salaries were £58 million, or 2 per cent, lower at £2,750 million in 2016 compared with £2,808 million in 2015, as the impact of headcount reductions, including the sale of TSB, has more than offset annual pay rises; pension costs were £7 million, or 1 per cent, higher at £555 million in 2016 compared to £548 million in 2015; social security costs were £14 million, or 4 per cent, higher at £363 million in 2016 compared with £349 million in 2015; and other staff costs were £26 million, or 6 per cent, lower at £433 million in 2016 compared with £459 million in 2015, in part due to lower levels of agency staff costs.

Premises and equipment costs were £43 million, or 6 per cent, lower at £672 million in 2016 compared to £715 million in 2015. Rent and rates was £3 million, or 1 per cent, lower at £365 million in 2016 compared to £368 million in 2015, in part due to charges in respect of onerous lease contracts as the Group rationalises its property portfolio; repairs and maintenance costs were £14 million, or 8 per cent, higher at £187 million in 2016 compared to £173 million in 2015 and other premises and equipment costs decreased by £54 million, or 31 per cent, from £174 million in 2015 to £120 million in 2016, partly reflecting gains on disposal of property, plant and equipment.

Other expenses, excluding the regulatory provisions charges, were £662 million, or 22 per cent, lower at £2,384 million in 2016 compared with £3,046 million in 2015. The Group had incurred a charge of £665 million in 2015 relating to the disposal of TSB, which was not repeated in 2016; excluding this charge, other expenses of £2,384 million in 2016 were £3 million higher than £2,381 million in 2015. Communications and data processing costs were £45 million, or 5 per cent, lower at £848 million in 2016 compared with £893 million in 2015 as a result of the sale of TSB and efficiency initiatives; professional fees were £3 million, or 1 per cent, higher at £265 million in 2016 compared to £262 million in 2015 as reduced costs following the sale of TSB have been offset by costs in relation to regulatory developments such as ring-fencing; and advertising and promotion costs were £55 million, or 22 per cent, lower at £198 million in 2016 compared with £253 million in 2015 as a result of the sale of TSB and reduced spend on certain marketing initiatives. The cost of the Bank levy was £70 million, or 26 per cent, lower at £200 million in 2016 compared to £270 million in 2015, as a result of reduced levels of chargeable liabilities. Other costs were £170 million, or 24 per cent, higher at £873 million in 2016 compared with £703 million in 2015.

Depreciation and amortisation costs were £268 million, or 13 per cent, higher at £2,380 million in 2016 compared with £2,112 million in 2015. Charges for the depreciation of tangible fixed assets were £227 million, or 15 per cent, higher at £1,761 million in 2016 compared to £1,534 million in 2015, in line with increased asset balances, in particular operating lease assets. The charge for the amortisation of other intangible assets was £45 million, or 8 per cent, higher at £582 million in 2016 compared to £537 million in 2015, reflecting increased capitalised software balances.

The Group incurred a regulatory provisions charge in operating expenses of £2,374 million in 2016 compared to £4,837 million in 2015 (in addition to £61 million, 2015: £nil, charged against income) of which £1,350 million (2015: £4,000 million) related to payment protection insurance.

IMPAIRMENT

	2017 £m	2016 £m	2015 £m
Impairment losses on loans and receivables:			
Loans and advances to customers	697	592	443
Debt securities classified as loans and receivables	(6)	–	(2)
Total impairment losses on loans and receivables	691	592	441
Impairment of available-for-sale financial assets	6	173	4
Other credit risk provisions	(9)	(13)	(55)
Total impairment charged to the income statement	688	752	390

2017 COMPARED WITH 2016

Impairment losses decreased by £64 million, or 9 per cent, to £688 million in 2017 compared to £752 million in 2016, as a charge of £118 million in the MBNA business since acquisition has offset the impact of the charge in respect of available-for-sale financial assets in 2016 which was not repeated in 2017.

The impairment charge in respect of loans and advances to customers was £105 million, or 18 per cent, higher at £697 million in 2017 compared to £592 million in 2016. In Retail, overall credit performance in the mortgage book remains stable. The average indexed loan to value (LTV) improved to 43.6 per cent (31 December 2016: 44.0 per cent) while the percentage of lending with an indexed LTV of greater than 100 per cent fell to 0.6 per cent (31 December 2016: 0.7 per cent). The UK Motor Finance book continues to benefit from conservative residual values and prudent provisioning and impaired loans as a percentage of closing advances were stable. The credit card book also continued to perform strongly with reductions in persistent debt while the MBNA portfolio performed in line with both the Group's expectations and the existing credit card book. Impaired credit card balances as a percentage of closing advances improved. Increased charges in Commercial Banking were driven by a lower level of releases and recoveries rather than a deterioration in the underlying portfolio, both 2016 and 2017 included material charges against a single customer (2016: oil and gas sector, 2017: construction sector), but otherwise gross charges have remained relatively low. The Commercial Banking portfolio continues to benefit from effective risk management, a relatively benign economic environment and continued low interest rates. The impairment charge relating to assets which are outside of the Group's risk appetite increased.

The impairment charge in respect of available-for-sale financial assets was £6 million in 2017, compared to £173 million in 2016, as a result of a charge in 2016 in respect of certain equity investments; and there was a credit of £9 million (2016: credit of £13 million) in respect of other credit risk provisions.

2016 COMPARED WITH 2015

Impairment losses increased by £362 million, or 93 per cent, to £752 million in 2016 compared to £390 million in 2015, largely due to lower levels of releases and write-backs and a charge in respect of available-for-sale financial assets.

The impairment charge in respect of loans and advances to customers was £149 million, or 34 per cent, higher at £592 million in 2016 compared to £443 million in 2015. In Retail, increased charges reflected a lower level of benefit from improvements in house prices in the secured book. The increased charges in Commercial Banking were driven by lower levels of releases and recoveries as well as overall growth in the consumer finance book and the non-recurrence of a favourable one-off release in 2015. The impairment charge relating to assets which are outside of the Group's risk appetite reduced, reflecting the continued run down of the portfolio.

The impairment charge in respect of available-for-sale financial assets was £173 million in 2016, compared to £4 million in 2015, as a result of a charge in respect of certain equity investments; and there was a credit of £13 million (2015: credit of £55 million) in respect of other credit risk provisions, in both years reflecting improved credit quality in a number of corporate relationships.

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TAXATION

	2017 £m	2016 £m	2015 £m
UK corporation tax:			
Current tax on profits for the year	(1,346)	(1,010)	(485)
Adjustments in respect of prior years	126	156	(90)
	(1,220)	(854)	(575)
Foreign tax:			
Current tax on profits for the year	(40)	(20)	(24)
Adjustments in respect of prior years	10	2	27
	(30)	(18)	3
Current tax (charge) credit	(1,250)	(872)	(572)
Deferred tax	(478)	(852)	(116)
Tax expense	(1,728)	(1,724)	(688)

2017 COMPARED WITH 2016

In 2017, a tax expense of £1,728 million arose on the profit before tax of £5,625 million and in 2016 a tax expense of £1,724 million arose on the profit before tax of £3,888 million. The statutory corporation tax rates were 19.25 per cent for 2017 and 20 per cent for 2016.

The tax expense for 2017 represents an effective tax rate of 31 per cent; the high effective tax rate in 2017 was largely due to the banking surcharge, and restrictions on the deductibility of conduct provisions.

2016 COMPARED WITH 2015

In 2016, a tax expense of £1,724 million arose on the profit before tax of £3,888 million and in 2015 a tax expense of £688 million arose on the profit before tax of £1,644 million. The statutory corporation tax rates were 20 per cent for 2016 and 20.25 per cent for 2015.

The tax expense for 2016 represented an effective tax rate of 44 per cent; the high effective tax rate in 2016 was largely due to the banking surcharge, restrictions on the deductibility of conduct provisions and the negative impact on the net deferred tax asset of both the change in corporation tax rate and the expected utilisation by the life assurance business.

LINE OF BUSINESS INFORMATION

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

The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources.

The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer and the performance assessment includes a consideration of each segment's net interest revenue; consequently the total interest income and expense for all reportable segments is presented on a net basis. The internal reporting is on an underlying profit before tax basis. The Group Executive Committee believes that this basis better represents the underlying performance of the Group. IFRS 8 requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements.

The aggregate total of the underlying basis segmental results constitutes a non-GAAP measure as defined in the United States Securities and Exchange Commission's Regulation G. Management uses aggregate underlying profit before tax, a non-GAAP measure, as a measure of performance and believes that it provides important information for investors because it is a comparable representation of the Group's performance. Profit before tax is the comparable GAAP measure to aggregate underlying profit before tax. The table below sets out the reconciliation of this non-GAAP measure to its comparable GAAP measure.

As part of a Group restructuring during 2017:

- the Consumer Finance division has now become part of Retail;
- the Group's UK wealth business, previously part of Retail, has been transferred to the Insurance division, now renamed Insurance and Wealth;
- the Group's International wealth business, previously part of Retail, has been transferred to the Commercial Banking division; and

- the Group’s venture capital business, previously part of Commercial Banking, has been transferred to Other.

Comparatives have been restated accordingly. Following this restructuring, the Group’s activities are now organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

Comparisons of results on a historical consolidated statutory basis are impacted by a number of items. In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on an ‘underlying’ basis. The following items are excluded in arriving at underlying profit:

- losses on redemption of the Enhanced Capital Notes and the volatility in the value of the embedded equity conversion feature;
- market volatility and asset sales, which includes the effects of certain asset sales, the volatility relating to the Group’s own debt and hedging arrangements and that arising in the insurance businesses and insurance gross up;
- the unwind of acquisition-related fair value adjustments and the amortisation of purchased intangible assets;
- restructuring costs comprising costs relating to the Simplification programme and the costs of implementing regulatory reform and ring fencing, rationalisation of the non-branch property portfolio and the integration of MBNA;
- TSB build and dual running costs and the loss relating to the TSB sale in 2015; and
- payment protection insurance and other conduct provisions,

The results of the businesses are set out below on the underlying basis:

	2017	2016 [1]	2015 [1]
	£m	£m	£m
Retail	4,403	4,058	4,255
Commercial Banking	2,489	2,379	2,383
Insurance and Wealth	939	973	1,090
Other	662	457	384
Underlying profit before tax	8,493	7,867	8,112

1 Segmental analysis restated, as explained above.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Reconciliation of underlying profit to statutory profit before tax for the year

	Note	2017 £m	2016 £m	2015 £m
Underlying profit before tax		8,493	7,867	8,112
Enhanced Capital Notes	1	–	(790)	(101)
Market volatility and asset sales	2	279	439	(81)
Amortisation of purchased intangibles	3	(91)	(340)	(342)
Restructuring and TSB dual running costs	4	(621)	(622)	(255)
Charge relating to TSB disposal	5	–	–	(660)
Fair value unwind and other items	6	(270)	(231)	(192)
Payment protection insurance provision	7	(1,300)	(1,350)	(4,000)
Other conduct provisions	8	(865)	(1,085)	(837)
Statutory profit before tax		5,625	3,888	1,644

1. Enhanced Capital Notes

The Group completed tender offers and redemptions in respect of its Enhanced Capital Notes (ECNs) in March 2016, resulting in a net loss to the Group of £721 million in the year ended 31 December 2016, principally comprising the write-off of the embedded equity conversion feature and premiums paid under the terms of the transaction. In addition there was a charge of £69 million reflecting the change in fair value of the embedded equity conversion feature in the period prior to the transaction.

In the year ended 31 December 2015, a charge of £101 million arose from the change in fair value of the embedded equity conversion feature.

2. Market volatility and asset sales

Market volatility and asset sales of £279 million included positive volatility in the insurance business of £286 million. The credit of £439 million in 2016 included the gain on sale of Visa Europe of £484 million partly offset by negative volatility in the insurance business of £91 million.

The Group’s statutory result before tax is affected by insurance volatility, caused by movements in financial markets, and policyholder interests volatility.

In 2017, the Group’s statutory result before tax included positive insurance and policyholder interests volatility totalling £286 million compared to negative volatility of £91 million in 2016 and negative volatility of £105 million in 2015.

Volatility comprises the following:

	2017	2016	2015
	£m	£m	£m
Insurance volatility	196	(152)	(303)
Policyholder interests volatility	190	241	87
Insurance hedging arrangements	(100)	(180)	111
Total	286	(91)	(105)

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

The most significant limitations associated with excluding volatility from the underlying basis results are:

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

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

Management compensates for the limitations above by:

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

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

Insurance volatility

The Group's insurance business has policyholder liabilities that are supported by substantial holdings of investments. IFRS requires that the changes in both the value of the liabilities and investments are reflected within the income statement. The value of the liabilities does not move exactly in line with changes in the value of the investments. As the investments are substantial, movements in their value can have a significant impact on the profitability of the Group. Management believes that it is appropriate to disclose the division's results on the basis of an expected return in addition to results based on the actual return. The impact of the actual return on these investments differing from the expected return is included within insurance volatility.

The expected gross investment returns used to determine the underlying profit of the business are based on prevailing market rates and published research into historical investment return differentials for the range of assets held. The basis for calculating these expected returns reflects an average of the 15 year swap rate over the preceding 12 months updated throughout the year to reflect changing market conditions. The positive insurance volatility during 2017 of £196 million primarily reflects positive returns on equities.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility.

Accounting standards require that tax on policyholder investment returns relating to life products should be included in the Group's tax expense rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the expected approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility. In 2017, the statutory profit before tax included a credit to other income which relates to policyholder interests volatility totalling £190 million reflecting movements in equity, bond and gilt returns relating to life products.

Insurance hedging arrangements

The Group purchased put option contracts in 2017 to protect against deterioration in equity market conditions and the consequent negative impact on the value of in-force business on the Group balance sheet. These were financed by selling some upside potential from equity market movements. A loss of £100 million was recognised in relation to these contracts in 2017, which was less than the gain from the underlying exposure.

3. Amortisation of purchased intangibles

The Group incurred a charge for the amortisation of intangible assets, principally those recognised on the acquisition of HBOS in 2009, of £91 million (2016: £340 million; 2015: £342 million); the lower charge in 2017 reflects the fact that the core deposit intangible arising from the HBOS acquisition is now fully amortised.

4. Restructuring costs and TSB build and dual-running costs

Restructuring costs in 2017 were £621 million and comprised severance costs relating to the Simplification programme, the rationalisation of the non-branch property portfolio, the integration of MBNA and the work on implementing the ring-fencing requirements.

Restructuring costs were £622 million in 2016 and comprised costs relating to the Simplification programme, the announced rationalisation of the non-branch property portfolio and the work on implementing the ring-fencing requirements. Restructuring costs of £170 million in 2015 related to the next phase of Simplification announced in October 2014.

During 2015, the Group completed the European Commission (EC) mandated business disposal of TSB. TSB dual-running costs in the year ended 31 December 2015 totalled £85 million. The dual-running costs included the costs of TSB's standalone treasury, finance, human resources and other head office functions.

5. Charge relating to TSB disposal

The Group completed the sale of a 9.99 per cent interest in TSB Banking Group plc (TSB) to Banco de Sabadell S.A. (Sabadell) on 24 March 2015, reducing the Group's holding in TSB to 40.01 per cent; this sale led to a loss of control and the deconsolidation of TSB. The Group's residual investment in 40.01 per cent of TSB was then recorded at fair value, as an asset held for sale. The Group recognised a loss of £660 million reflecting the net costs of the Transitional Service Agreement between Lloyds and TSB, the contribution to be provided by Lloyds to TSB in moving to alternative IT provision and the net result on sale of the 9.99 per cent interest and fair valuation of the residual investment.

The Group announced on 30 June 2015 that all relevant regulatory clearances for the sale of its remaining 40.01 per cent holding in TSB to Sabadell had been received and that the sale was therefore unconditional in all respects; the proceeds were received on 10 July 2015.

6. Fair value unwind and other items

The statutory (IFRS) results include the impact of the acquisition-related fair value adjustments, principally those arising from the acquisition of HBOS in 2009; these adjustments affect a number of line items.

The principal financial effects of the fair value unwind are to reflect the effective interest rates applicable at the date of acquisition, on assets and liabilities that were acquired at values that differed from their original book value, and to recognise the reversal of credit and liquidity risk adjustments as underlying instruments mature or become impaired. Generally, this leads to higher interest expense as the value of HBOS's own debt accretes to par and a lower impairment charge reflecting the impact of acquisition balance sheet valuation adjustments.

7. Payment protection insurance provision

There was a charge of £1,300 million (2016: £1,350 million; 2015: £4,000 million) in respect of Payment Protection Insurance (PPI), claim levels having increased as expected in the third quarter of 2017 following the FCA advertising campaign and increased marketing activity from claims management companies (CMCs). The remaining provision is consistent with an average of 11,000 complaints per week (higher than the Group's previously assumed run-rate of about 9,000 per week) through to the industry deadline of August 2019.

8. Other conduct provisions

Other conduct provisions of £865 million (2016: £1,085 million; 2015: £837 million) cover a number of items including £245 million in relation to packaged bank accounts and £245 million in respect of arrears handling. Following a review of the Group's arrears handling activities, the Group has put in place a number of actions to improve further its handling of customers in these areas and has made good progress in reimbursing mortgage arrears fees to the 590,000 impacted customers. The Group is also currently undertaking a review of the HBOS Reading fraud and is in the process of paying compensation to the victims of the fraud for economic losses as well as ex-gratia payments and awards for distress and inconvenience. A provision of £100 million was taken and reflects the estimated compensation costs for HBOS Reading.

DIVISIONAL RESULTS

RETAIL

Retail offers a broad range of financial service products, including current accounts, savings, mortgages, credit cards, motor finance and unsecured loans to personal and business banking customers. Its aim is to be the best bank for customers in the UK, by building deep and enduring relationships that deliver value to customers, and by providing them with greater choice and flexibility. Retail operates a multi-brand and multi-channel strategy and continues to simplify the business and provide more transparent products, helping to improve service levels and reduce conduct risks, whilst working within a prudent risk appetite.

	2017	2016[1]	2015[1]
	£m	£m	£m
Net interest income	8,706	8,073	8,253
Other income	2,217	2,162	2,263
Total income	10,923	10,235	10,516
Operating lease depreciation	(946)	(775)	(720)
Net income	9,977	9,460	9,796
Operating expenses	(4,857)	(4,748)	(4,958)
Impairment	(717)	(654)	(583)
Underlying profit	4,403	4,058	4,255

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

Underlying profit increased by £345 million, or 9 per cent, to £4,403 million in 2017 compared to £4,058 million in 2016, including MBNA which was acquired on 1 June 2017.

Net interest income increased by £633 million, or 8 per cent, to £8,706 million in 2017 compared to £8,073 million in 2016, reflecting the acquisition of MBNA and driven by deposit repricing offsetting mortgage margin pressures.

Other income increased £55 million, or 3 per cent, to £2,217 million in 2017 compared to £2,162 million in 2016, driven by continued fleet growth in Lex Autolease.

Operating lease depreciation increased £171 million, or 22 per cent, to £946 million in 2017 compared to £775 million in 2016, again driven by continued fleet growth in Lex Autolease and increased conservatism in residual value management.

Operating expenses increased by £109 million, or 2 per cent, to £4,857 million in 2017 compared to £4,748 million in 2016 mainly due to the inclusion of MBNA as well as increased investment spend and pay-related growth, partly offset by underlying efficiency savings.

Impairment increased by £63 million, or 10 per cent, to £717 million in 2017 compared to £654 million in 2016, largely due to the addition of MBNA, partly offset by a lower charge reflecting the resilient economic environment.

2016 COMPARED WITH 2015

Underlying profit decreased by £197 million, or 5 per cent, to £4,058 million in 2016 compared to £4,255 million in 2015, reflecting the challenging interest rate environment and continued pressure on other operating income.

Net interest income decreased by £180 million, or 2 per cent, to £8,073 million in 2016 compared to £8,253 million in 2015, largely due to a reduction in mortgage balances following the focus on maximising margins as well as lower hedge income partly offset by continued growth in Black Horse.

Other income decreased £101 million, or 4 per cent, to £2,162 million in 2016 compared to £2,263 million in 2015, driven by changing customer behaviour and improvements to the customer propositions along with market-wide reduction in credit card interchange fees, partly offset by continued fleet growth in Lex Autolease.

Operating lease depreciation increased £55 million, or 8 per cent, to £775 million in 2016 compared to £720 million in 2015, driven by the continued fleet growth in Lex Autolease.

Operating expenses decreased by £210 million, or 4 per cent, to £4,748 million in 2016 compared to £4,958 million in 2015 with continued investment in the business more than offset by underlying efficiency savings.

Impairment increased by £71 million, or 12 per cent, to £654 million in 2016 compared to £583 million in 2015. Underlying credit quality remained stable.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMMERCIAL BANKING

Commercial Banking has a client-led, low risk, capital efficient strategy, helping UK-based clients and international clients with a link to the UK. Through its four client facing segments – SME, Mid Markets, Global Corporates and Financial Institutions – it provides clients with a range of products and services such as lending, transactional banking, working capital management, risk management and debt capital markets services.

	2017	2016[1]	2015[1]
	£m	£m	£m
Net interest income	3,086	2,934	2,774
Other income	1,761	1,756	1,842
Total income	4,847	4,690	4,616
Operating lease depreciation	(44)	(105)	(30)
Net income	4,803	4,585	4,586
Operating expenses	(2,199)	(2,189)	(2,225)
Impairment	(115)	(17)	22
Underlying profit	2,489	2,379	2,383

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

Commercial Banking underlying profit increased by £110 million, to £2,489 million in 2017 compared to £2,379 million in 2016 due to income growth and active cost management.

Net interest income increased by £152 million, or 5 per cent, to £3,086 million in 2017 compared to £2,934 million in 2016 with an improvement in net interest margin supported by broad based franchise growth and increased net asset margin.

Other income increased by £5 million to £1,761 million in 2017 compared to £1,756 million in 2016 despite fewer significant transactions in the second half and reduced client activity.

Operating lease depreciation decreased by £61 million to £44 million in 2017 compared to £105 million in 2016 due to lower accelerated charges.

Operating expenses increased by £10 million to £2,199 million in 2017 compared to £2,189 million in 2016.

Impairments increased by £98 million, to £115 million charge in 2017 compared to £17 million in 2016, driven by a lower level of releases and recoveries rather than a deterioration in the underlying portfolio; both 2016 and 2017 included material charges against a single customer (2016: oil and gas sector, 2017: construction sector), but otherwise gross charges have remained relatively low.

2016 COMPARED WITH 2015

Commercial Banking underlying profit decreased by £4 million, to £2,379 million in 2016 compared to £2,383 million in 2015 due to additional charges relating to certain leasing assets partially offset by total income growth.

Net interest income increased by £160 million, or 6 per cent, to £2,934 million in 2016 compared to £2,774 million in 2015 with an improvement in net interest margin supported by high quality deposit growth, disciplined deposit pricing and reduced funding costs.

Other income decreased by £86 million, or 5 per cent, to £1,756 million in 2016 compared to £1,842 million in 2015 driven by non-recurring income recognised in 2015, relating to refinancing support of Global Corporates clients.

Operating lease depreciation increased by £75 million to £105 million in 2016 compared to £30 million in 2015 due to additional charges relating to certain leasing assets.

Operating expenses decreased by £36 million to £2,189 million in 2016 compared to £2,225 million in 2015.

Impairments increased by £39 million, to a charge of £17 million in 2016 compared to a release of £22 million in 2015.

INSURANCE AND WEALTH

Insurance and Wealth offers insurance, investment and wealth management products and services. It supports over 9 million customers with total customer assets under management of £145 billion and annualised annuity payments to customers in retirement of approximately £1 billion. The division's strategic aim is to be the best insurer and wealth management business in the UK. It is committed to providing trusted, value for money products and services to meet the needs of its customers.

	2017	2016[1]	2015[1]
	£m	£m	£m
Net interest income	133	80	59
Other income	1,846	1,939	1,986
Total income, net of insurance claims	1,979	2,019	2,045
Operating expenses	(1,040)	(1,046)	(954)
Impairment	–	–	(1)
Underlying profit	939	973	1,090

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

Underlying profit from Insurance and Wealth was £34 million, or 3 per cent lower at £939 million compared to £973 million in 2016 as a result of lower Wealth income. Income in insurance and overall costs remained flat, with higher investment costs offset by lower business as usual costs.

Net interest income increased by £53 million, or 66 per cent, to £133 million from £80 million in 2016 due to a lower net interest expense within Insurance reflecting reduced funding costs.

Other income decreased by £93 million, or 5 per cent, to £1,846 million from £1,939 million in 2016 reflecting lower margins in Insurance as a result of the competitive environment, strengthening of underlying assumptions and lower bulk annuity sales. General insurance income fell due to the continued competitiveness of the home insurance marketplace.

Total costs were £6 million lower, with higher investment costs offset by lower business as usual costs.

2016 COMPARED WITH 2015

Underlying profit from Insurance and Wealth was £117 million, or 11 per cent lower at £973 million compared to £1,090 million in 2015. A 17 per cent increase in insurance new business income was more than offset by adverse economics impacting insurance existing business income together with increased investment costs.

Net interest income increased by £21 million, or 35 per cent, to £80 million from £59 million in 2015 due to a lower net interest expense within Insurance from lower interest rates. Net interest income within Wealth remained steady.

Other income decreased by £47 million, or 2 per cent, to £1,939 million from £1,986 million in 2015. The decrease was driven by adverse economics impacting existing business income partly offset by the four bulk annuity deals completed in the year. General insurance income net of claims increased as a result of lower weather related claims.

Total costs were £92 million higher reflecting increased investment and £28 million annual levy associated with the Flood Re scheme.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INCOME BY PRODUCT GROUP

	2017			2016[1]			2015[1]		
	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m
Workplace	107	96	203	123	103	226	140	134	274
Planning and retirement	95	91	186	109	95	204	40	94	134
Bulk annuities	54	26	80	121	16	137	125	–	125
Protection	13	20	33	19	17	36	12	19	31
Longstanding life, pensions and investments	12	440	452	9	441	450	9	526	535
	281	673	954	381	672	1,053	326	773	1,099
Life and pensions experience and other items			358			202			242
General Insurance			298			354			323
			1,610			1,609			1,664
Wealth			369			410			381
Total income			1,979			2,019			2,045

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

New business income has decreased by £100 million to £281 million. Excluding bulk annuities and 2016 with profits fund annuity transfer within planning and retirement, new business income remains stable.

Existing business income has increased by £1 million to £673 million, with positive impact of economics offset by legacy products run-off.

Experience and other items contributed a net benefit of £358 million, including benefits as a result of changes to longevity assumptions. These include both experience in the annuity portfolio and the adoption of a new industry model reflecting an updated view of future life expectancy.

2016 COMPARED WITH 2015

New business income has increased by £55 million to £381 million driven by growth in planning and retirement and protection propositions. This has more than offset lower income from workplace.

Existing business income has decreased by £101 million, primarily driven by adverse economics.

There was a net benefit of £202 million as a result of experience and other items. This included one off benefits following an update to the methodology for calculating the illiquidity premium and the addition of a new death benefit to legacy pension contracts, to align terms with other pensions products. These were partly offset by the effect of recent reforms on activity within the pensions market.

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OTHER

Other comprises Run-off, the results of TSB up until loss of control in March 2015 and Central items.

Run-off

Run-off comprises assets classified as outside the Group's risk appetite.

	2017 £m	2016 £m	2015 £m
Net interest expense	(91)	(110)	(88)
Other income	42	120	145
Total income	(49)	10	57
Operating lease depreciation	(63)	(15)	(14)
Net income	(112)	(5)	43
Operating expenses	(54)	(77)	(150)
Impairment release (charge)	41	26	(8)
Underlying loss	(125)	(56)	(115)

2017 COMPARED WITH 2016

The underlying loss deteriorated by £69 million to £125 million in 2017 compared to £56 million in 2016, with reduced income and operating costs both reflecting further reductions in these portfolios of lending which are outside of the Group's risk appetite.

Net interest expense improved by £19 million, or 17 per cent, to £91 million in 2017 compared to £110 million in 2016, however other income reduced by £78 million, or 65 per cent, to £42 million in 2017 compared to £120 million in 2016.

There was an increase of £48 million in the charge for operating lease depreciation, net of profits on sale of operating lease assets, from £15 million in 2016 to £63 million in 2017.

Operating costs were £23 million, or 30 per cent, lower at £54 million in 2017 compared to £77 million in 2016 and there was an increased impairment release of £41 million which was £15 million, or 58 per cent, higher than the release of £26 million in 2016.

2016 COMPARED WITH 2015

The underlying loss of £56 million was an improvement of £59 million compared to the loss of £115 million in 2015.

Total income decreased by £47 million to £10 million in 2016 compared to £57 million in 2015, in particular reflecting reduced fee and other income as the portfolio continues to run off.

Operating expenses were £73 million, or 49 per cent, lower at £77 million compared to £150 million in 2015 reflecting the reducing costs of managing the portfolio as it runs down.

Impairment was a credit of £26 million compared to a charge of £8 million in 2015, in particular reflecting a credit in 2016 compared to a charge in 2015 in relation to Irish lending.

Central items

Central items includes income and expenditure not attributed to divisions, including the costs of certain central and head office functions and the Group’s private equity business, Lloyds Development Capital.

	2017	2016[1]	2015[1]
	£m	£m	£m
Total income	825	546	403
Operating expenses	(34)	(33)	(24)
Impairment (charge) release	(4)	–	2
Underlying profit	787	513	381

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

The underlying profit in Central items was £274 million, or 53 per cent, higher at £787 million in 2017 compared to £513 million in 2016.

Total income increased by £279 million, or 51 per cent, from £546 million in 2016 to £825 million in 2017 largely as a result of the gain of £146 million on the sale of the Group’s interest in Vocalink and the gains on sales of liquid assets, including gilts, of £ 274 million (2016: £112 million).

Operating expenses were £1 million, or 3 per cent, higher at £34 million in 2017 compared to £33 million in 2016.

There was a small impairment charge of £4 million in 2017 (2016: £nil).

2016 COMPARED WITH 2015

The underlying profit in Central items was £132 million, or 35 per cent, higher at £513 million in 2016 compared to £381 million in 2015.

Total income increased by £143 million, or 35 per cent, from £403 million in 2015 to £546 million in 2016, largely as a result of sales of liquid assets including gilts, and the timing of dividends from the Group’s strategic investments.

Operating expenses were £9 million, or 38 per cent, higher at £33 million in 2016 compared to £24 million in 2015.

There was a small impairment credit of £2 million in 2015 but this was not repeated in 2016.

TSB

TSB served retail and small business customers; providing a full range of retail banking products. The Group sold its controlling interest in TSB in March 2015 and ceased to consolidate TSB's results at that point.

	2017 £m	2016 £m	2015 £m
Net interest income	–	–	192
Other income	–	–	31
Total income	–	–	223
Operating expenses	–	–	(86)
Impairment	–	–	(19)
Underlying profit	–	–	118

TSB results are shown on a Lloyds Banking Group reporting basis. The costs of TSB's head office functions are excluded from underlying profit.

2016 COMPARED WITH 2015

Because TSB was sold during 2015, no results were consolidated in 2016, this compared to a profit of £118 million in 2015, for the period up to sale in March 2015.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2017 Average balance £m	Interest income £m	Yield %	2016 Average balance £m	Interest income £m	Yield %	2015 Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	67,049	271	0.40	82,409	381	0.46	94,543	397	0.42
Loans and advances to customers	464,944	14,712	3.16	457,622	15,190	3.32	464,012	16,256	3.50
Debt securities	3,332	43	1.29	3,797	56	1.47	2,139	40	1.87
Available-for-sale financial assets	50,049	980	1.96	40,604	762	1.88	40,967	725	1.77
Held-to-maturity investments	–	–	–	16,003	231	1.44	13,256	197	1.49
Total interest-earning assets of banking book	585,374	16,006	2.73	600,435	16,620	2.77	614,917	17,615	2.86
Total interest-earning trading securities and other financial assets at fair value through profit or loss	79,754	1,772	2.22	81,961	1,594	1.94	87,583	1,955	2.23
Total interest-earning assets	665,128	17,778	2.67	682,396	18,214	2.67	702,500	19,570	2.79
Allowance for impairment losses on loans and receivables	(2,161)			(2,536)			(4,729)		
Non-interest earning assets	155,853			148,965			145,224		
Total average assets and interest income	818,820	17,778	2.17	828,825	18,214	2.20	842,995	19,570	2.32

	2017 **Average interest earning assets £m**	**Net interest income £m**	**Net interest margin %**	2016 Average interest earning assets £m	Net interest income £m	Net interest margin %	2015 Average interest earning assets £m	Net interest income £m	Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	585,374	10,912	1.86	600,435	9,274	1.54	614,917	11,318	1.84
	79,754	1,294	1.62	81,961	1,060	1.29	87,583	1,205	1.38

Trading securities and other financial assets at fair value through profit or loss	665,128	12,206	1.84	682,396	10,334	1.51	702,500	12,523	1.78

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2017			2016			2015		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders' funds									
Deposits by banks	6,758	80	1.18	10,540	68	0.65	10,442	43	0.41
Customer deposits	348,683	1,722	0.49	366,178	2,520	0.69	380,137	3,299	0.87
Liabilities to banks and customers under sale and repurchase agreements	18,943	110	0.58	8,342	38	0.46	5,960	34	0.57
Debt securities in issue[1]	72,762	266	0.37	85,030	799	0.94	85,462	586	0.69
Amounts payable to unitholders in consolidated open-ended investment vehicles	15,675	1,435	9.15	18,961	2,057	10.85	21,059	244	1.16
Subordinated liabilities	18,674	1,481	7.93	22,330	1,864	8.35	24,975	2,091	8.37
Total interest-bearing liabilities of banking book	481,495	5,094	1.06	511,381	7,346	1.44	528,035	6,297	1.19
Total interest-bearing liabilities of trading book	55,288	478	0.86	50,700	534	1.05	61,560	750	1.22
Total interest-bearing liabilities	536,783	5,572	1.04	562,081	7,880	1.40	589,595	7,047	1.20
Interest-free liabilities									
Non-interest bearing customer accounts	66,276			54,379			45,294		
Other interest-free liabilities	166,403			163,688			158,852		
Non-controlling interests and shareholders' funds	49,358			48,677			49,254		
Total average liabilities and interest expense	818,820	5,572	0.68	828,825	7,880	0.95	842,995	7,047	0.84

1 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.43 per cent (2016: 2.70 per cent; 2015: 2.76 per cent).

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

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CHANGES IN NET INTEREST INCOME – VOLUME AND RATE ANALYSIS

The following table allocates changes in net interest income between volume and rate for 2017 compared with 2016 and for 2016 compared with 2015. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2017 compared with 2016 Increase/(decrease)			2016 compared with 2015 Increase/(decrease)		
	Total change £m	Volume £m	Rate £m	Total change £m	Volume £m	Rate £m
Interest receivable and similar income						
Loans and receivables:						
Loans and advances to banks	(110)	(61)	(49)	(16)	(56)	40
Loans and advances to customers	(478)	231	(709)	(1,066)	(212)	(854)
Debt securities	(13)	(6)	(7)	16	24	(8)
Available-for-sale financial assets	218	185	33	37	(7)	44
Held-to-maturity investments	(231)	(231)	–	34	40	(6)
Total banking book interest receivable and similar income	(614)	118	(732)	(995)	(211)	(784)
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	178	(49)	227	(361)	(109)	(252)
Total interest receivable and similar income	(436)	69	(505)	(1,356)	(320)	(1,036)
Interest payable						
Deposits by banks	12	(45)	57	25	1	24
Customer deposits	(798)	(86)	(712)	(779)	(96)	(683)
Liabilities to banks and customers under sale and repurchase agreements	72	60	12	4	10	(6)
Debt securities in issue	(533)	(45)	(488)	213	(4)	217
Amounts payable to unitholders in consolidated open-ended investment vehicles	(622)	(301)	(321)	1,813	(228)	2,041
Subordinated liabilities	(383)	(290)	(93)	(227)	(221)	(6)
Total banking book interest payable	(2,252)	(707)	(1,545)	1,049	(538)	1,587
Total interest payable on trading and other liabilities at fair value through profit or loss	(56)	39	(95)	(216)	(114)	(102)
Total interest payable	(2,308)	(668)	(1,640)	833	(652)	1,485

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK OVERVIEW

Effective risk management and control

As a Group, managing risk effectively is fundamental to the Group's strategy and to operating successfully. The Group is a simple, low risk, UK focused bank with a culture founded on a prudent through the cycle risk appetite.

A strong risk management culture is crucial for sustainable growth and within Lloyds it is at the heart of everything the Group does.

The Group's approach to risk is founded on an effective control framework, which guides how its colleagues work, behave and the decisions they make. Risk appetite – the amount and type of risk the Group is prepared to seek, accept or tolerate – is approved by the Board and embedded in policies, authorities and limits across the Group.

The Group's prudent risk culture and appetite, along with close collaboration between Risk division and the business, supports effective decision making and has enabled the Group to continue to deliver against its strategic priorities in 2017, simplifying and strengthening the business whilst growing in targeted areas. The Group has created a strong foundation to enable this progress, ensuring it reacts appropriately to the ever changing macroeconomic and regulatory environment.

RISK AS A STRATEGIC DIFFERENTIATOR

Group strategy and risk appetite are developed together to ensure one informs the other to deliver on the Group's purpose to help Britain prosper whilst becoming the best bank for customers, colleagues and shareholders.

Risks are identified, managed and mitigated using the Group's comprehensive Risk Management Framework (see overleaf), and the Group's well articulated risk appetite provides a clear framework for effective decision making. The principal risks the Group faces, which could significantly impact the delivery of its strategy, are discussed on pages 39–44.

The Group believes effective risk management can be a strategic differentiator, in particular:

Prudent approach to risk

Implementing a prudent approach to risk across the Group and embedding a strong risk culture ensures alignment to the Group's strategy.

Strong control framework

The Group's Risk Management Framework is the foundation for the delivery of effective risk control and ensures that the Group risk appetite is continually developed and adhered to.

Business focus and accountability

Effective risk management is a key focus and is included in key performance measures against which business units are assessed. Business units in the first line of defence are accountable for risk with oversight from a strong and independent, second line of defence Risk division.

Effective risk analysis, management and reporting

Continuing to deliver regular close monitoring and stringent reporting to all levels of management and the Board ensures appetite limits are maintained and subject to stressed analysis at a risk type and portfolio level.

Sustainable growth

Embedding a risk culture that ensures proactive support and constructive challenge takes place across the business is important for delivering sustainable growth.

THE GROUP'S RISK MANAGEMENT FRAMEWORK

The diagram below outlines the framework in place for risk management across the Group.

RISK CONSIDERATIONS

The potential risks and impacts arising from the external environment are outlined below, with links to the Group's principal risks and strategic priorities. For information on how the Group manages its emerging risks, see page 47.

The links shown here between these five factors and the Group's principal risks and strategic priorities are not an exhaustive list.

ECONOMY

Risk and potential impact

Economic headwinds such as rising inflation could impact households' disposable income and businesses' profitability, impairing customers' ability to repay their borrowing, and potentially hindering sustainable growth.

The impact of EU exit on the Group's portfolios remains uncertain. Operational changes are likely to be limited given the Group's UK focus but the impact on the UK economy may affect business performance.

The Group considers an array of scenarios as part of its operating plan and stress testing exercises, to identify and implement appropriate mitigating actions.

Link to principal risks

Credit
Operational
Insurance underwriting
Capital
Funding and liquidity
Market

Link to strategic priorities

Maximising the Group’s capabilities
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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

REGULATION AND LEGAL

Risk and potential impact

The financial services industry continues to experience significant legislative and regulatory change and interpretation giving rise to uncertainty surrounding the nature, scale and complexity of implementation requirements.

This has the potential to impact, for example, the resource and investment available to allocate to the Group's strategic priorities.

The Group has a proven track record in implementing complex legal and regulatory programmes and will continue to manage any potential impact by remaining actively engaged with governmental bodies, regulatory authorities and industry associations.

Link to principal risks

Credit
Regulatory and legal
Capital
Funding and liquidity
Market

Link to strategic priorities

Delivering a leading customer experience

CUSTOMER

Risk and potential impact

The availability and delivery of services through digital channels is becoming increasingly important for customer satisfaction. Accelerated change in customer behaviour and expectations may require increased agility to accommodate the pace and scale of change and could lead to customer detriment if this change is poorly executed.

The Group will continue to focus on change execution whilst keeping pace with developments to meet new and evolving customer needs.

Link to principal risks

Regulatory and legal
Conduct
Operational

Link to strategic priorities

Delivering a leading customer experience

TECHNOLOGY

Risk and potential impact

New technologies such as public cloud and artificial intelligence along with growing interconnectivity between the Group, customers, and third parties create new risks.

Increasing capabilities of cyber-attackers and higher volumes of connected devices increases the potential for cyber-enabled fraud and other crime, including attacks that could disrupt service for customers.

The Group continues to optimise its approach to operational resilience by enhancing systems that support the Group's critical business processes, evolving controls within new technologies and channels, and making significant investment to improve data privacy, including the security of data.

Link to principal risks

Conduct
Operational

Link to strategic priorities

Delivering a leading customer experience
Digitising the Group
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COMPETITION

Risk and potential impact

Technological change is driving an increase in the number, and changing the nature of competitors in the UK financial services industry, opening up opportunities for consumers even as levels of regulatory focus rise.

The Group must ensure that an unexpectedly fast pace of change, which may accelerate customer disintermediation, does not lead to its involvement in anti-competitive practices, or prevent certain customer groups from having equal access to its products and services.

The Group will continue to address this through innovation and developing new products that respond to market trends and meet customer changing needs.

Link to principal risks

Regulatory and legal
Conduct
Operational
People

Link to strategic priorities

Delivering a leading customer experience
Maximising the Group's capabilities

PRINCIPAL RISKS

The most significant risks which could impact the delivery of the Group's long-term strategic objectives and the Group's approach to each risk, are detailed below.

As part of the Group's ongoing assessment of the potential implications of the UK leaving the European Union, the Group continues to consider the impact to its customers, colleagues and products – as well as legal, regulatory, tax, financial and capital implications.

There remains continued uncertainty around both the UK and global political and macroeconomic environment. The potential impacts of external factors have been considered in all principal risks to ensure any material uncertainties continue to be monitored and are appropriately mitigated.

Principal risks and uncertainties are reviewed and reported regularly. This year the Group has added a new principal risk, model risk, to reflect the Group's increasing use of analytics and models to make decisions.

Credit

The risk that parties with whom the Group has contracted, fail to meet their financial obligations (both on and off balance sheet).

Example

Adverse impact on profitability due to an increase in impairment losses, write downs and/or decrease in asset valuations which can occur for a number of reasons, including adverse changes in the economic, geopolitical and market environment. For example, low interest rates have helped customer affordability, but there is a risk of increased defaults as interest rates rise.

Key mitigating actions

Credit policy, incorporating prudent lending criteria, aligned with Board approved risk appetite, to effectively manage risk.

Robust risk assessment and credit sanctioning to ensure the Group lends appropriately and responsibly.

Extensive and thorough credit processes and controls to ensure effective risk identification, management and oversight.

Effective, well-established governance process supported by independent credit risk assurance.

Early identification of signs of stress leading to prompt action in engaging the customer.

Key risk indicators

Impairment charge	Impaired assets
£795m	**£7,841m**
2016: £645m	2016: £8,495m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group seeks to support sustainable growth in its targeted segments. The Group has a conservative and well balanced credit portfolio, managed through the economic cycle and supported by strong credit portfolio management.

The Group is committed to better addressing its customers' banking needs through consistent, fair and responsible credit risk decisions, aligned to customers' circumstances, whilst staying within prudent risk appetite.

Impairments remain below long-term levels and are expected to increase as the level of write-backs and releases reduces and impairments normalise.

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Regulatory and legal

The risks of changing legislation, regulation, policies, voluntary codes of practice and their interpretation in the markets in which the Group operates may have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

Examples

Increased regulatory oversight and prudential regulatory requirements.

Increased legislative requirements, such as ring-fencing legislation, Payment Services Directive 2 (PSD2), Open Banking and General Data Protection Regulation (GDPR).

Key mitigating actions

Ensure the Group develops comprehensive plans for delivery of all legal and regulatory changes and track their progress. Group-wide projects implemented to address significant impacts.

Continued investment in people, processes, training and IT to assess impact and help meet the Group's legal and regulatory commitments.

Engage with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations.

Key risk indicators

Mandatory, legal and regulatory investment spend

£886m

2016: £555m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

The Group is committed to operating sustainably and responsibly, and commits significant resource and expense to ensure it meet its legal and regulatory obligations.

The Group responds as appropriate to impending legislation, regulation and associated consultations and participates in industry bodies. The Group continues to be subject to significant ongoing and new legislation, regulation and court proceedings.

Conduct

Conduct risk can arise from a number of areas including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; failing to promote effective competition in the interest of customers; and exhibiting behaviours which could impact on the integrity of the market or undermine wider regulatory standards.

Example

The most significant conduct cost in recent years has been PPI mis-selling.

Key mitigating actions

Conduct risk appetite metrics provide a granular view of how the Group's products and services are performing for customers.

Product approval, continuous product review processes and customer outcome testing (across products and services) supported by conduct management information.

Learning from past mistakes through root cause analysis and clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics.

Further enhancements and embedding of the Group's framework to support customers in vulnerable circumstances.

Key risk indicators

Conduct risk
appetite metric
performance-Group
92.3%
2016: 92.1%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

As the Group transforms its business, minimising conduct risk is critical to achieving the Group's strategic goals and meeting regulatory standards.

The Group's focus on embedding a customer-centric culture and delivering good outcomes through good conduct is subject to robust review by the Group Customer First Committee. This supports the Group's vision of being the best bank for customers, enabling the delivery of a leading customer experience through effective root cause analysis and learning from customer feedback.

Operational

The Group faces significant operational risks which may disrupt services to customers, cause reputational damage, and result in financial loss. These include the availability, resilience and security of the Group's core IT systems, unlawful or inappropriate use of customer data, theft of sensitive data, fraud and financial crime threats, and the potential for failings in the Group's customer processes.

Example

The dynamic threat posed by cyber risk to the confidentiality and integrity of electronic data or the availability of systems.

Key mitigating actions

- Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems, and to ensure effective third party assurance.
- Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis.
- Significant investment in compliance with GDPR and Basel Committee on Banking Supervision standards.
- Working with industry bodies and law enforcement agencies to identify and combat fraud and money laundering.

Key risk indicators

Availability of core systems

99.98%

2016: 99.97%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

The Group recognises that resilient and secure technology, and appropriate use of data, is critical to delivering a leading customer experience and maintaining trust across the wider industry.

The availability and resilience of IT systems remains a key strategic priority and the Cyber Programme continues to focus on enhancing cyber security controls. Internal programmes ensure that data is used correctly, and the control environment is regularly assessed through both internal and third party testing.

People

Key people risks include the risk that the Group fails to maintain organisational skills, capability, resilience and capacity levels in response to organisational, political and external market change and evolving business needs.

Example

Inability to attract or retain colleagues with key skills could impact the achievement of business objectives.

Key mitigating actions

Focused action to attract, retain and develop high calibre people. Delivering initiatives which reinforce behaviours to generate the best outcomes for customers and colleagues.

Managing organisational capability and capacity to ensure there are the right skills and resources to meet the Group's customers' needs.

Effective remuneration arrangements to promote appropriate colleague behaviours and meet regulatory expectations.

Key risk indicators
Best bank for customers index
80%
2016: 77%

Alignment to strategic priorities and future focus

Transforming ways of working

Continued regulatory change relating to personal accountability and remuneration rules could affect the Group's ability to attract and retain the calibre of colleagues required to meet the Group's changing customer needs. The Group will continue to invest in the development of colleague capabilities and agile working practices in order to deliver a leading customer experience, and to respond quickly to the rapidly evolving change in customers' decision making in an increasingly digital marketplace.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance underwriting

Key insurance underwriting risks within the Insurance business are longevity, persistency and property insurance. Longevity risk is expected to increase as the Group's presence in the bulk annuity market increases.

Example

Uncertain property insurance claims impact Insurance earnings and capital, e.g. extreme weather conditions, such as flooding, can result in high property damage claims.

Key mitigating actions

Processes for underwriting, claims management, pricing and product design seek to control exposure. Longevity and bulk pricing experts support the bulk annuity proposition.

The merits of longevity risk transfer and hedging solutions are regularly reviewed for the Insurance business.

Property insurance exposures are mitigated by a broad reinsurance programme.

Key risk indicators

Insurance (Life and Pensions) present value of new business premiums	General Insurance underwritten total gross written premiums
£9,951m	**£733m**
2016: £8,919m	2016: £831m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

The Group is committed to meeting the changing needs of customers by working to provide a range of insurance products via multiple channels. The focus is on delivering a leading customer experience by helping customers protect themselves today whilst preparing for a secure financial future.

Strategic growth initiatives within Insurance are developed and managed in line with a defined risk appetite, aligned to the Group risk appetite and strategy.

Capital

The risk that the Group has a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the Group.

Example

A worsening macroeconomic environment could lead to adverse financial performance, which could deplete capital resources and/or increase capital requirements due to a deterioration in customers' creditworthiness.

Key mitigating actions

A comprehensive capital management framework that includes setting of capital risk appetite and dividend policy.

Close monitoring of capital and leverage ratios to ensure the Group meets regulatory requirements and risk appetite.

Comprehensive stress testing analyses to evidence capital adequacy under various adverse scenarios.

Key risk indicators

Common equity tier 1 ratio[1,2]	UK leverage ratio[1,3]
13.9%	**5.4%**
2016: 12.9%	2016: 5.2%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

Ensuring the Group holds an appropriate level of capital to maintain financial resilience and market confidence, underpins the Group's strategic objectives of supporting the UK economy and growth in targeted segments.

1 Adjusted basis.

2 CET1 ratio after ordinary dividends and share buyback. 2016 adjusted for MBNA.

3 Calculated in accordance with the UK Leverage Ratio Framework which requires qualifying central bank claims to be excluded from the leverage exposure measure.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Funding and liquidity

The risk that the Group has insufficient financial resources to meet its commitments as they fall due.

Example

A deterioration in either the Group's or the UK's credit rating, or a sudden and significant withdrawal of customer deposits, would adversely impact the Group's funding and liquidity position.

Key mitigating actions

Holding liquid assets to cover potential cash and collateral outflows and to meet regulatory requirements. In addition, maintaining a further pool of assets that can be used to access central bank liquidity facilities.

Undertaking daily monitoring against a number of market and Group-specific early warning indicators.

Maintaining a contingency funding plan detailing actions and strategies available in stressed conditions.

Key risk indicators

LCR eligible assets	Loan to deposit ratio
£121bn	**110%**
2016: £121bn	2016: 109%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group maintains a strong funding position in line with its low risk strategy and the loan to deposit ratio remains within the Group's target range. The Group's funding position allows the Group to grow targeted business segments and better address its customers' needs.

Governance

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from meeting the requirements to ring-fence core UK financial services and activities from January 2019 and further requirements under the Senior Manager & Certification Regime (SM&CR).

Examples

Inadequate or complex governance arrangements to address ring-fencing requirements could result in a weaker control environment, delays in decision making and lack of clear accountability.

Non-compliance with or breaches of SM&CR requirements could result in lack of clear accountability and legal and regulatory consequences.

Key mitigating actions

Leveraging the Group’s considerable change experience to meet ring-fencing requirements before the regulatory deadlines, and the continuing evolution of SM&CR.

Programme in place to address ring-fencing. In close and regular contact with regulators to develop and deploy the Group’s planned operating and legal structure.

Evolving risk and governance arrangements to continue to be appropriate to comply with regulatory objectives.

Key risk indicators

N/A

Alignment to strategic priorities and future focus

Delivering a leading customer experience

Ring-fencing will ensure the Group becomes safer and continues to deliver a leading customer experience by providing further protection to core retail and SME deposits, increasing transparency of the Group's operations and facilitating the options available in resolution.

The Group's governance framework and strong culture of ownership and accountability enabled effective, on time, compliance with the SM&CR requirements and enable the Group to demonstrate clear accountability for decisions.

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Market

The risk that the Group's capital or earnings profile is affected by adverse market rates, in particular interest rates and credit spreads in the banking business, equity and credit spreads in the Insurance business, and credit spreads in the Group's defined benefit (DB) pension schemes.

Examples

Earnings are impacted by the Group's ability to forecast and model customer behaviour accurately and establish appropriate hedging strategies.

The Insurance business is exposed indirectly to equity risk through the value of future management charges on policyholder funds. Credit spread risk within the Insurance business primarily arises from bonds and loans used to back annuities.

Narrowing credit spreads will increase the cost of pension scheme benefits.

Key mitigating actions

Structural hedge programmes implemented to manage liability margins and margin compression.

Equity and credit spread risks are closely monitored and, where appropriate, asset and liability matching is undertaken.

The Group's DB pension schemes have increased their credit allocation and hedged against nominal rate and inflation movements.

Key risk indicators
IAS19 Pension surplus
£509m
2016: £(244)m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group actively manages its exposure to movements in market rates, to drive lower volatility earnings and offer a comprehensive customer proposition with hedging strategies to support strategic aims. Mitigating actions are implemented to reduce the impact of market movements, resulting in a more stable capital position. Effective interest rate and inflation hedging has kept volatility in the Group's DB pension schemes low and helped to return the schemes to IAS19 surplus in 2017. This allows the Group to more efficiently utilise available capital resources to better enable the Group to maximise its capabilities.

Model (NEW)

The risk of financial loss, regulatory censure, reputational damage or customer detriment, as a result of deficiencies in the development, application and ongoing operation of financial models and rating systems.

Examples

Examples of the consequences of inadequate models include:

- Inappropriate levels of capital or impairments.
- Inappropriate credit or pricing decisions.
- Adverse impacts on funding or liquidity, or the Group's earnings and profits.

Key mitigating actions

A comprehensive model risk management framework including:

- Defined roles and responsibilities, with clear ownership and accountability.
- Principles regarding the requirements of data integrity, development, validation, implementation and ongoing maintenance.
- Regular model monitoring.

Independent review of models.

Periodic validation and re-approval of models.

Key risk indicators

N/A

Alignment to strategic priorities and future focus

Digitising the Group

The Group's models play a vital role in supporting Group strategy to ensure profitable growth in targeted segments and the Group's drive toward automation and digital solutions to enhance customer outcomes. Model risk management helps ensure these models are implemented in a controlled and safe manner for both the Group and customers.

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RISK MANAGEMENT

Risk management is at the heart of the Group's strategy to become the best bank for customers.

The Group's mission is to support the business in delivering sustainable growth in targeted segments. This is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture.

The risk overview (pages 36–44) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, along with a brief overview of the Group's Risk Management Framework, the potential risks and impacts arising from the external environment, and the principal risks faced by the Group and key mitigating actions.

This full risk management section provides a more in-depth picture of how risk is managed within the Group, detailing the Group's emerging risks, approach to stress testing, risk governance, committee structure, appetite for risk (pages 45–54) and a full analysis of the primary risk categories (pages 54–108) – the framework by which risks are identified, managed, mitigated and monitored.

Each risk category is described and managed using the following standard headings: definition, exposures, measurement, mitigation and monitoring.

The Group's approach to risk

The Group operates a prudent approach to risk with rigorous management controls to support sustainable business growth and minimise losses. Through a strong and independent risk function (Risk division) a robust control framework is maintained to identify and escalate current and emerging risks to support sustainable business growth within Group risk appetite and through good risk reward decision making.

RISK CULTURE

The Board ensures that senior management implements risk policies and risk appetite that either limit or, where appropriate, prohibit activities, relationships and situations that could be detrimental to the Group's risk profile.

As part of a conservative business model that embodies a risk culture founded on a prudent approach to managing risk, the Group reviewed its code of responsibility in 2017, reinforcing its approach under which colleagues are accountable for the risks they take and for prioritising their customers' needs.

The focus remains on building and sustaining long-term relationships with customers cognisant of the economic climate.

RISK APPETITE

Risk appetite is defined as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate.'

Risk appetite is documented in a Group risk appetite statement which is reviewed by the Board Risk Committee and approved annually by the Board. The Group level metrics are supported by more detailed sub Board functional and divisional risk appetite metrics.

As a key component of the Risk Management Framework, Group risk appetite is embedded within principles, policies, authorities and limits across the Group and continues to evolve to reflect external market developments and composition of the Group.

The Group's strategy operates in tandem with the Group risk appetite and business planning is undertaken with a view to meeting the requirements of the Group risk appetite. Performance is optimised by allowing business units to operate within approved risk appetite and limits.

The Board Risk Committee is responsible for overseeing the development, implementation and maintenance of the Group's overall Risk Management Framework including its risk appetite, to ensure these are in line with emerging regulatory, corporate governance and industry best practice.

Group risk appetite includes the following areas:

Credit – the Group has a conservative and well balanced credit portfolio through the economic cycle, generating an appropriate return on equity, in line with the Group's target return on equity in aggregate.

Conduct – the Group's product design and sales practices ensure that products are transparent and meet customer needs.

Market – the Group has robust controls in place to manage the Group's inherent market risk and does not engage in any proprietary trading, reflecting the customer focused nature of the Group's activities.

Operational – the Group has robust controls in place to manage operational losses, reputational events and regulatory breaches.

Funding and liquidity – the Group maintains a prudent liquidity profile and a balance sheet structure that limits its reliance on potentially volatile sources of funding.

Capital – the Group maintains capital levels commensurate with a prudent level of solvency, and aims to deliver consistent and high quality earnings.

Regulatory and legal – the Group complies with all relevant regulation and all applicable laws (including codes of practice which have legal implications) and/or legal obligations.

People – the Group leads responsibly and proficiently, manages its people resource effectively, supports and develops colleague talent, and meets legal and regulatory obligations related to its people.

Governance – the Group has governance arrangements that support the effective long-term operation of the business, maximise shareholder value and meet regulatory and societal expectations.

Model – the Group has embedded a framework for the management of model risk to ensure effective control and oversight, compliance with all regulatory rules and standards, and to facilitate appropriate customer outcomes.

Financial reporting – the Group meets regulatory reporting and tax requirements in jurisdictions where it operates.

As separate regulated entities with their own Boards, the Insurance business and Lloyds Bank Corporate Markets each maintain their own risk appetite and framework, which are aligned to the Group risk appetite framework.

GOVERNANCE AND CONTROL

The Group's approach to risk is founded on a robust control framework and a strong risk management culture which are the foundation for the delivery of effective risk management and guide the way all employees approach their work, behave and make decisions.

Governance is maintained through delegation of authority from the Board down to individuals through the management hierarchy. Senior executives are supported by a committee based structure which is designed to ensure open challenge and support effective decision making.

The Group's risk appetite, principles, policies, procedures, controls and reporting are regularly reviewed and updated where needed to ensure they remain fully in line with regulations, law, corporate governance and industry good-practice.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.

Board-level engagement, coupled with the direct involvement of senior management in Group-wide risk issues at Group Executive Committee level, ensures that escalated issues are promptly addressed and remediation plans are initiated where required.

Line managers are directly accountable for identifying and managing risks in their individual businesses, ensuring that business decisions strike an appropriate balance between risk and reward and are consistent with the Group's risk appetite.

Clear responsibilities and accountabilities for risk are defined across the Group through a three lines of defence model which ensures effective independent oversight and assurance in respect of key decisions.

FINANCIAL REPORTING RISK MANAGEMENT SYSTEMS AND INTERNAL CONTROLS

The Group maintains risk management systems and internal controls relating to the financial reporting process, which are designed to:

- ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;
- enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements;
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements and as far as possible are consistent with best practice and in compliance with the UK Finance Code for Financial Reporting Disclosure.

The financial reporting process is actively monitored at business unit and Group levels. There are specific programmes of work undertaken across the Group to support:

- annual assessments of (i) the effectiveness of internal controls over financial reporting; and (ii) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act; and

- annual certifications by the Senior Accounting Officer with respect to the maintenance of appropriate tax accounting arrangements, in accordance with the requirements of the 2009 Finance Act.

The Group also has in place an assurance process to support its prudential regulatory reporting and monitoring activities designed to identify and review tax exposures on a regular basis. There is ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

The Group has a Disclosure Committee which assists the Group Chief Executive and Chief Financial Officer in fulfilling their disclosure responsibilities under relevant listing and other regulatory and legal requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see pages 156–159.

RISK DECISION MAKING AND REPORTING

Taking risks which are well understood, consistent with strategy and with appropriate return is a key driver of shareholder value.

Risk analysis and reporting supports the identification of opportunities as well as risks.

An aggregate view of the Group's overall risk profile, key risks and management actions, and performance against risk appetite, is reported to and discussed monthly at the Group Risk Committee (and a subset at the Group Asset and Liability Committee), with regular reporting to the Board Risk Committee and the Board.

Rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform strategic planning.

The Chief Risk Officer regularly informs the Board Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of Board Risk Committee.

Table 1.1: Exposure to risk arising from the business activities of the Group

The table below provides a high level guide to how the Group's business activities are reflected through its risk-weighted assets. Details of the business activities for each division are provided in the Divisional results on pages 27–32.

	Retail	Commercial Banking	Insurance & Wealth[1]	Run-off	Central items[2]	Group
	£bn	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
Risk-weighted assets (RWAs)						
– Credit risk	71.1	71.2	0.6	7.1	14.5	164.5
– Counterparty credit risk[3]	–	7.1	–	–	0.8	7.9
– Market risk	–	3.0	–	–	0.1	3.1
– Operational risk	19.7	4.3	0.7	0.2	0.4	25.3
Total (excluding threshold)	90.8	85.6	1.3	7.3	15.8	200.8
–Threshold[4]					10.1	10.1
Total	90.8	85.6	1.3	7.3	25.9	210.9

1 As a separate regulated business, Insurance (excluding Wealth) maintains its own regulatory solvency requirements, including appropriate management buffers, and reports directly to the Insurance Board. Insurance does not hold any RWAs, as its assets are removed from the Banking Group's regulatory capital calculations. However, in accordance with Capital Requirements Directive and Regulation (CRD IV) rules, part of the Group's investment in Insurance is included in the calculation of threshold RWAs, while the remainder is taken as a capital deduction.

2 Central items include assets held outside the main operating divisions, including assets relating to Group Corporate Treasury which holds the Group's liquidity portfolio, and Group Operations.

3 Exposures relating to the default fund of a central counterparty and credit valuation adjustment risk are included in counterparty credit risk.

4 Threshold is presented on a fully loaded CRD IV basis. Threshold risk-weighted assets reflect the proportion of significant investments and deferred tax assets that are permitted to be risk-weighted instead of deducted from common equity tier 1 (CET1) capital. Significant investments primarily arise from the investment in the Group's Insurance business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PRINCIPAL RISKS

The Group's principal risks are shown in the risk overview (pages 39–44). The Group's emerging risks are shown below. Full analysis of the Group's risk categories is on pages 54–108.

EMERGING RISKS

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group. These risks are considered alongside the Group's operating plan.

Risk	Key mitigating actions
Regulatory and legal: The industry continues to witness increased government and regulatory intervention in the financial sector with increasing regulatory rules and laws from both the UK and overseas affecting the Group's operation.	– The Group continues to embed the regulatory and legal agenda across all areas of the Group ensuring that the customer is at the heart of the Group's business planning.
There remains uncertainty as to the impact of EU exit on the regulatory and legal landscape; for example, the ability that the UK can continue to share data under the new data protection regime (both with other European countries and internationally) after EU exit.	– The Group works closely with regulatory authorities and industry bodies to ensure that the Group can identify and respond to the evolving regulatory and legal landscape. – The Group actively implements programmes to deliver regulatory and legal change requirements.
Macroeconomic headwinds and political uncertainties: Uncertainty over the UK's eventual relationship with the EU, and the implications of a minority UK government, create a more uncertain outlook for the UK economy. A rise in global protectionism led by the US, fuelled by growing income inequality and an accompanying rise in political populism, and the recent indecisive German election, generate heightened risks to the global political and macroeconomic environment.	– Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts, with a plan specifically for working through the potential impacts of the EU exit on the Group.

Further, high levels of credit market liquidity have reduced spreads and weakened terms in some sectors, creating a potential under-pricing of risk.	– Engagement with politicians, officials, media, trade and other bodies to reassure the Group's commitment to helping Britain prosper. – Wide array of risks considered in setting strategic plans. – Capital and liquidity is reviewed regularly through committees, ensuring compliance with risk appetite and regulatory requirements. – Continued investment in IT and to improve the effectiveness of the Group's IT resilience.
IT resilience and cyber: Increasing digitisation places greater reliance on the provision of resilient and secure services to customers. Continued increase in the volume and sophistication of cyber-attacks could disrupt service for customers, causing financial loss/reputational damage.	– Continued investment in the Group's Cyber Programme to ensure confidentiality and integrity of data and availability of key systems. – Collaboration with regulators and law enforcement agencies. – The Group is transforming the business to improve customer experience by digitising customer journeys and leveraging branches for complex needs, in response to customers' evolving needs and expectations.
Response to market changes (agility): As technology and customer needs change, the typical banking model is evolving and as such, operational complexity has the potential to restrict the Group's speed of response.	– The Group will deepen insight into customer segments, their perception of brands and what they value. – Agility will be increased by consolidating platforms and building new architecture aligned with customer journeys.
Strategic use of customer data: The implementation of open banking introduces data sharing with third parties, potentially increasing the risks	– The Group has implemented open banking and is actively monitoring the

of fraud and data loss. There is a continued need to defend against dynamic external challengers and meet consumer expectations. Failure to address growth in data movement or understand the supply chain/third party controls may increase exposure to cyber and fraud leading to conduct and reputational issues.	implications for its customers, including protecting them from fraud. – The Group is making a significant investment to improve data privacy, including the security of data and oversight of third parties. – The Group's strategy is to introduce advanced data management practices, based on Group-wide standards, data-first culture and modern enterprise data platforms, supported by a simplified modern IT architecture.
	– Risk appetite criteria limits single counterparty bank and non-bank exposures complemented by a UK-focused strategy.
Geopolitical shocks: Current uncertainties could further impede the global economic recovery. Events in North Korea, Russia, the Middle-East, as well as terrorist activity, have the potential to trigger changes in the economic outlook, market risk pricing and funding conditions.	– The Chief Security Office develops and maintains the Stability Response Plan with the Financial Stability Response Team acting as a rapid reaction group, should an external crisis occur. – The Chief Security Office also maintains the operational resilience framework to embed resilience activities across the Group and limit the impact of internal or external events.

Capital stress testing

OVERVIEW

Stress testing is recognised as a key risk management tool within the Group by the Board, senior management, the businesses and the Risk and Finance functions. It is fully embedded in the planning process of the Group as a key activity in medium term planning, and senior management is actively involved in stress testing activities via a strict governance process.

The Group uses scenario stress testing for:

Risk identification:

- To understand key vulnerabilities of the Group under adverse economic conditions.

Risk appetite:

- Assess the results of the stress test against the Group's risk appetite to ensure the Group is managed within its risk parameters.
- Inform the setting of risk appetite by assessing the underlying risks under stress conditions.

Strategic and capital planning:

- Allow senior management and the Board to adjust strategies if the plan does not meet risk appetite in a stressed scenario.
- Support the Internal Capital Adequacy Assessment Process (ICAAP) by demonstrating capital adequacy, and meet the requirements of regulatory stress tests that are used to inform the setting of the Group's Prudential Regulation Authority (PRA) and management buffers (see capital risk on pages 87–94).

Risk mitigation:

– Drive the development of potential actions and contingency plans to mitigate the impact of adverse scenarios. Stress testing also links directly to the Group's recovery planning process.

REGULATORY STRESS TESTS

The concurrent UK stress test run by the Bank of England was also undertaken in 2017. As announced in November, despite the severity of the stress scenario, the Group exceeded the capital and leverage thresholds set out for the purpose of the stress test and was not required to take any capital action as a result.

INTERNAL STRESS TESTS

On at least an annual basis, the Group conducts macroeconomic stress tests of the operating plan, which are supplemented with higher-level refreshes if necessary. The exercise aims to highlight the key vulnerabilities of the Group's business plan to adverse changes in the economic environment, and to ensure that there are adequate financial resources in the event of a downturn.

REVERSE STRESS TESTING

Reverse stress testing is used to explore the vulnerabilities of the Group's strategies and plans to extreme adverse events that would cause the business to fail, in order to facilitate contingency planning. The scenarios used are those that would cause the Group to be unable to carry on its business activities. Where reverse stress testing reveals plausible scenarios with an unacceptably high risk when considered against the Group's risk appetite, the Group will adopt measures to prevent or mitigate that risk, which are then reflected in strategic plans.

OTHER STRESS TESTING ACTIVITY

The Group's stress testing programme also involves undertaking assessment of liquidity scenarios, market risk sensitivities and scenarios, and business specific scenarios (see the primary risk categories on pages 54–108 for further information on risk specific stress testing). If required, ad hoc stress testing exercises are also undertaken to assess emerging risks, as well as in response to regulatory requests. This wide ranging programme provides a comprehensive view of the potential impacts arising from the risks to which the Group is exposed and reflects the nature, scale and complexity of the Group.

METHODOLOGY

The stress tests at all levels must comply with all regulatory requirements, achieved through comprehensive construction of macroeconomic scenarios and a rigorous divisional, functional, risk and executive review and challenge process, supported by analysis and insight into impacts on customers and business drivers.

The engagement of all required business, Risk and Finance areas is built into the preparation process, so that the appropriate analysis of each risk category's impact upon the business plans is understood and documented. The methodologies and modelling approach used for stress testing ensure that a clear link is shown between the macroeconomic scenarios, the business drivers for each area and the resultant stress testing outputs. All material assumptions used in modelling are documented and justified, with a clearly communicated review and sign-off process. Modelling is supported by expert judgement and is subject to the Group Model Governance Policy.

GOVERNANCE

Clear accountabilities and responsibilities for stress testing are assigned to senior management and the Risk and Finance functions throughout the Group. This is formalised through the Group Business Planning and Stress Testing Policy and Procedure, which are reviewed at least annually.

The Group Financial Risk Committee (GFRC), chaired by the Chief Risk Officer and attended by the Chief Financial Officer and other senior Risk and Finance colleagues, is the Committee that has primary responsibility for overseeing the development and execution of the Group's stress tests.

The review and challenge of the detailed stress forecasts, the key assumptions behind these, and the methodology used to translate the economic assumptions into stressed outputs conclude with the divisional Finance Directors', appropriate Risk Directors' and Managing Directors' sign-off. The outputs are then presented to GFRC, Group Asset and Liability Committee/Group Risk Committee/Group Executive Committee and Board Risk Committee for Group level executive and non-executive review and challenge, before being approved by the Board.

How risk is managed in Lloyds Banking Group

The Group's Risk Management Framework (RMF) (see risk overview, page 37), is structured around the following components which meet and align with the industry-accepted internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

The RMF applies to every area of the business and covers all types of risk. It is reviewed, updated and approved by the Board at least annually to reflect any changes in the nature of the Group's business and external regulations, law, corporate governance and industry best practice. In 2017 the annual update was also informed by the findings of an independent external review. The RMF provides the Group with an effective mechanism for developing and embedding risk policies and risk management strategies which are aligned with the risks faced by its businesses. It also seeks to facilitate effective communication on these matters across the Group.

ROLE OF THE BOARD AND SENIOR MANAGEMENT

Key responsibilities of the Board and senior management include:

– setting risk appetite and approval of the RMF;

– approval of Group-wide risk principles and policies;

– the cascade of delegated authority (for example to Board sub-committees and the Group Chief Executive); and

– effective oversight of risk management consistent with risk appetite.

RISK APPETITE

Risk appetite is defined within the Group as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate' (see the Group's approach to risk', pages 45–46).

GOVERNANCE FRAMEWORKS

The policy framework is founded on Board-approved key principles for the overall management of risk in the organisation, which are aligned with Group strategy and risk appetite and based on a current and comprehensive risk profile that identifies all material risks to the organisation. The principles are underpinned by a hierarchy of policies which define mandatory requirements for risk management and control which are consistently implemented across the Group.

Regular policy framework assessments are undertaken in all business areas, driving Board-level risk appetite metrics which monitor the operating effectiveness of policy controls and overall policy implementation. Robust processes and controls to identify and report policy breaches include clear materiality criteria and escalation procedures which ensure an appropriate level of visibility and prioritisation of remedial actions.

The risk committee governance framework is outlined on page 51.

THREE LINES OF DEFENCE MODEL

The RMF is implemented through a 'three lines of defence' model which defines clear responsibilities and accountabilities and ensures effective independent oversight and assurance activities take place covering key decisions.

Business lines (first line) have primary responsibility for risk decisions, identifying, measuring, monitoring and controlling risks within their areas of accountability. They are required to establish effective governance and control frameworks for their business to be compliant with Group policy requirements, to maintain appropriate risk management skills, mechanisms and toolkits, and to act within Group risk appetite parameters set and approved by the Board.

Risk division (second line) is a centralised function headed by the Chief Risk Officer and consisting of eight Risk Directors and their specialist teams. The role of Chief Risk Officer was held by Juan Colombás until 4 September 2017 when he was succeeded by Stephen Shelley, previously Commercial Banking Risk Director. Within Risk division the Compliance function has been headed throughout 2017 by Letitia Smith, Group Director, Conduct, Compliance and Operational Risk.

Risk division provides oversight and independent constructive challenge to the effectiveness of risk decisions taken by business management, providing proactive advice and guidance, reviewing, challenging and reporting on the risk profile of the Group and ensuring that mitigating actions are appropriate.

It also has a key role in promoting the implementation of a strategic approach to risk management reflecting the risk appetite and RMF agreed by the Board that encompasses:

- embedded effective risk management processes;
- transparent, focused risk monitoring and reporting;
- provision of expert and high quality advice and guidance to the Board, executives and management on strategic issues and horizon scanning, including pending regulatory changes; and
- a constructive dialogue with the first line through provision of advice, development of common methodologies, understanding, education, training, and development of new tools.

The Chief Risk Officer is accountable for developing and leading an industry-wide recognised Risk function that adds value to the Group by:

- providing a regular comprehensive view of the Group's risk profile, both current and emerging key risks, and management actions;
- (with input from the business areas and Risk division) proposing Group risk appetite to the Board for approval, and overseeing performance of the Group against risk appetite;
- developing an effective RMF which meets regulatory requirements for approval by the Board, and overseeing execution and compliance; and
- challenging management on emerging risks and providing expert risk and control advice to help management maintain an effective risk and control framework.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Risk Directors:

- provide independent advice, oversight and challenge to the business;
- design, develop and maintain policies, specific functional risk type frameworks and guidance to ensure alignment with business imperatives and regulatory requirements;
- establish and maintain appropriate governance structures, culture, oversight and monitoring arrangements which ensure robust and efficient compliance with relevant risk type risk appetites and policies;
- lead regulatory liaison on behalf of the Group including horizon scanning and regulatory development for their risk type; and
- recommend risk appetite and oversight of the associated risk profile across the Group.

Group Internal Audit (third line) provides independent and objective assurance designed to add value and improve the organisation's operations. Group Internal Audit has been headed throughout 2017 by Paul Day, Chief Internal Auditor, on an interim secondment basis from 1 January to 31 May, and on a permanent basis thereafter. It helps the Group accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. Group Internal Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Internal Audit is fully independent of the business and the Risk division, and seeks to ensure objective challenge to the effectiveness of the risk governance framework.

RISK AND CONTROL CYCLE FROM IDENTIFICATION TO REPORTING

To allow senior management to make informed risk decisions, the business follows a continuous risk management approach which includes producing appropriate, accurate and focused risk reporting and risk management. The risk and control cycle sets out how this should be approached and produced with the appropriate controls and processes in place. This cycle, from identification to reporting, ensures consistency and is intended to manage and mitigate the risks impacting the Group.

The process for risk identification, measurement and control is integrated into the overall framework for risk governance. Risk identification processes are forward looking to ensure emerging risks are identified. Risks are captured and measured using robust and consistent quantification methodologies. The measurement of risks includes the application of stress testing and scenario analysis, and considers whether relevant controls are in place before risks are incurred.

Identified risks are reported on a monthly basis or as frequently as necessary to the appropriate committee. The extent of the risk is compared to the overall risk appetite as well as specific limits or triggers. When thresholds are breached, committee minutes are clear on the actions and timeframes required to resolve the breach and bring risk within given tolerances. There is a clear process for escalation of risks and risk events.

All business areas complete a Control Effectiveness Review (CER) annually, reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. The CER reports are approved at divisional risk committees or directly by the relevant member of the Group Executive Committee to confirm the accuracy of the assessment. This key process is overseen and independently challenged by Risk division, reviewed by Group Internal Audit against the findings of its assurance activities, and reported to the Board.

RISK CULTURE

Supporting the formal frameworks of the RMF is the underlying culture, or shared behaviours and values, which sets out in clear terms what constitutes good behaviour and good practice. In order to effectively manage risk across the organisation, the functions encompassed within the three lines of defence have a clear understanding of risk appetite, business strategy and an understanding of (and commitment to) the role they play in delivering it. A number of levers are used to reinforce the risk culture, including tone from the top, clear accountabilities, effective communication and challenge and an appropriately aligned performance incentive and structure.

RISK RESOURCES AND CAPABILITIES

Appropriate mechanisms are in place to avoid over-reliance on key personnel or system/technical expertise within the Group. Adequate resources are in place to serve customers both under normal working conditions and in times of stress, and monitoring procedures are in place to ensure that the level of available resource can be increased if required. Colleagues undertake appropriate training to ensure they have the skills and knowledge necessary to enable them to deliver fair outcomes for customers, being mindful of the Group’s strategic conduct agenda, customer treatment policy/standards and Financial Conduct Authority requirements.

There is ongoing investment in risk systems and models alongside the Group’s investment in customer and product systems and processes. This drives improvements in risk data quality, aggregation and reporting leading to effective and efficient risk decisions.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk governance

The risk governance structure below is integral to effective risk management across the Group. Risk division is appropriately represented on key committees to ensure that risk management is discussed in these meetings. This structure outlines the flow and escalation of risk information and reporting from business areas and Risk division to Group Executive Committee and Board. Conversely, strategic direction and guidance is cascaded down from the Board and Group Executive Committee.

Company Secretariat support senior and Board level committees, and support the Chairs in agenda planning. This gives a further line of escalation outside the three lines of defence.

Table 1.2: Risk governance structure

Group Chief Executive Committees	**Business area principal Enterprise Risk Committees**	**Risk Division Committees and Governance**
Group Executive Committee (GEC)		**Credit risk**
	Commercial Banking Risk Committee	– Executive Credit Approval Committee
Group Risk Committee (GRC)		– Commercial Banking Credit Risk Committees
	Retail Risk Committee	
Group Asset and Liability Committee (GALCO)		– Retail Credit Risk Committees
	Insurance and Wealth Risk Committee	**Market risk**
Group Customer First Committee	Community Banking Risk Committee	– Group Market Risk Committee
		Conduct, compliance and operational risk
Group Cost Management Committee	Group Services Risk Committee	– Group Conduct, Compliance and Operational Risk Committee
	Transformation Risk Committee	**Fraud and financial crime risk**
Conduct Review Committee		– Group Fraud and Financial Crime Prevention Committee
	Finance Risk Committee	**Financial risk**

Group People Committee

Responsible Business

Management Committee

Senior Independent Performance

Adjustment and Conduct Committee

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People and Productivity Risk Committee

Group Corporate Affairs Risk Committee

– Group Financial Risk Committee

Capital risk

– Group Capital Risk Committee

Model risk

– Group Model Governance Committee

Insurance underwriting risk through the governance arrangements for Insurance Group (Insurance Group is a separate regulated entity with its own Board, governance structure and Chief Risk Officer)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Board, Executive and Risk Committees

The Group's risk governance structure (see table 1.2) strengthens risk evaluation and management, while also positioning the Group to manage the changing regulatory environment in an efficient and effective manner.

Assisted by the Board Risk and Audit Committees, the Board approves the Group's overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 138–164, for further information on Board committees.

The divisional and functional risk committees review and recommend divisional and functional risk appetite and monitor local risk profile and adherence to appetite.

Insurance, which is subject to separate regulation, has its own Board and governance structure. The Insurance Board, assisted by a Risk Oversight Committee and Audit Committee, approves the governance, risk and control frameworks for the Insurance business and the Insurance business risk appetite, ensuring it aligns with the Group's framework and risk appetite.

Table 1.3: Executive and Risk Committees

The Group Chief Executive is supported by the following:

Committees	**Risk focus**
Group Executive Committee (GEC)	Supports the Group Chief Executive in exercising his authority in relation to material matters having strategic, cross-business area or Group-wide implications.
Group Risk Committee (GRC)	Reviews and recommends the Group's risk appetite and governance, risk and control frameworks, and material Group policies. The committee also regularly reviews risk exposures and risk/reward returns and approves models that are material at Group level.
Group Asset and Liability Committee (GALCO)	Responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
Group Customer First Committee	Provides a Group-wide perspective on the progress of Group's, divisions' and functions' implementation of initiatives which enhance the delivery of customer outcomes and customer trust, and sets and promotes the appropriate tone from the top to fulfil the Group's vision to become the best bank for customers and help Britain prosper.

Group Cost Management Committee	Leads and shapes the Group's approach to cost management, ensuring appropriate governance and process over Group-wide cost management activities and effective control of the Group's cost base.
Conduct Review Committee	Provides oversight and challenge in connection with the Group's engagement with conduct review matters as agreed with the Group Chief Executive.
Group People Committee	Oversees the Group's colleague policy, remuneration policy and Group-wide remuneration matters, oversees compliance with Senior Manager and Certification Regime (SM&CR) and other regulatory requirements, monitors colleague engagement surveys and ensures that colleague-related issues are managed fairly, effectively and compliantly.
Responsible Business Management Committee	Recommends and implements the strategy and plans to deliver the Group's aspiration to be a leader in responsible business as part of the objective of helping Britain prosper.
Senior Independent Performance Adjustment and Conduct Committee	Responsible for providing recommendations regarding performance adjustment, including the individual risk adjustment process and risk adjusted performance assessment, and making final decisions on behalf of the Group on the appropriate course of action relating to conduct breaches, under the formal scope of the SM&CR.

The Group Risk Committee is supported through escalation and ongoing reporting by business area risk committees, cross-divisional committees addressing specific matters of Group-wide significance and the following second line of defence Risk committees which ensure effective oversight of risk management:

Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee	Monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Group Conduct, Compliance and Operational Risk Committee	Responsible for monitoring breaches, material events and risk issues, and conducting deep dive assessments on specific conduct, compliance or operational risk subjects to inform corrective action along with the sharing of information and best practice.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Committees	Risk focus
Group Fraud and Financial Crime Prevention Committee	Reviews and challenges the management of fraud and financial crime risk including overall strategy and performance, Group-level risk appetite and broader corporate responsibilities, and engagement with relevant authorities and other external parties. The committee is accountable for ensuring that, at Group level, current and emerging fraud and financial crime risks are effectively identified and managed within appetite, and that strategies and investments to improve fraud and financial crime prevention are co-ordinated and implemented in relevant business areas.
Group Financial Risk Committee	Responsible for reviewing, challenging and recommending to GEC, GRC and GALCO, the Group Individual Liquidity Adequacy Assessment (ILAAP) and Internal Capital Adequacy Assessment Process (ICAAP) submissions, Pillar 3 Disclosures, the Group recovery and resolution plans, and the annual stress testing of the Group's operating plan, Prudential Regulation Authority (PRA) and European Banking Authority (EBA) stress tests, and any other analysis as required.
Group Capital Risk Committee	Responsible for providing oversight of all relevant capital matters within the Group including the Group's capital position, Pillar 2 requirements, regulatory reform and accounting developments specific to capital, as well as other areas such as stress testing and modelling activity. It also reviews regulatory submissions including the ICAAP and recovery plan prior to submission to Group Financial Risk Committee.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's modelling framework, specifically regarding consistency of approach across business units and risk types. It approves banking models other than those material at Group level, which are approved by GRC, and meets the PRA requirements regarding the governance and approval for Internal Ratings Based (IRB) methodologies. An equivalent committee exists in the Insurance division for approval of insurance models.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Full analysis of risk categories

The Group's risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. A detailed description of each category is provided on pages 54–108.

Following a review of the Group's risk categories in 2017, model risk is now a primary risk category, and is described in detail on page 108. Financial reporting risk, previously a primary risk category, is now considered as a secondary risk category of operational risk (see pages 84–85; additionally the main features of the Group's internal control system in relation to the financial reporting process are described on page 46).

Primary risk categories	**Secondary risk categories**		
Credit risk Page 54	– Retail credit	– Commercial credit	
Regulatory and legal risk Page 82	– Regulatory compliance	– Legal	
Conduct risk Page 83	– Conduct		
Operational risk	– Business process	– External service provision	– Internal service provision
Page 84	– Change	– Financial crime	– IT systems
	– Cyber and information security	– Financial reporting	– Operational resilience
	– Data management	– Fraud	– Physical security/health and safety
	– Sourcing		
People risk Page 85	– People		
Insurance underwriting risk Page 86	– Insurance underwriting		
Capital risk Page 87	– Capital		
Funding and liquidity risk	– Funding and liquidity		

The Group considers both reputational and financial impact in the course of managing all its risks and therefore does not classify reputational impact as a separate risk category.

CREDIT RISK

DEFINITION

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their financial obligations (both on and off balance sheet).

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances, contingent liabilities, commitments, debt securities and derivatives to customers, financial institutions and sovereigns. The credit risk exposures of the Group are set out in note 51 on page F-78. Credit risk exposures are categorised as 'retail', arising primarily in the Retail and Run-off divisions, and some small and medium sized enterprises (SMEs) and 'corporate' (including larger SMEs, corporates, banks, financial institutions and sovereigns) arising primarily in the Commercial Banking, Run-off and Insurance and Wealth divisions and Group Corporate Treasury (GCT).

In terms of loans and advances, (for example loans and overdrafts) and contingent liabilities (for example credit instruments such as guarantees and standby, documentary and commercial letters of credit), credit risk arises both from amounts advanced and commitments to extend credit to a customer or bank. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit may be cancelled and the creditworthiness of customers is monitored regularly. Most commercial term commitments to extend credit are contingent upon customers maintaining specific credit standards, which together with the creditworthiness of customers are monitored regularly.

Credit risk also arises from debt securities and derivatives. The total notional principal amount of interest rate, exchange rate, credit derivative and other contracts outstanding at 31 December 2017 is shown on page 62. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 51 on page F-78.

Additionally, credit risk arises from leasing arrangements where the Group is the lessor. Note 2(J) on page F-14 provides details on the Group's approach to the treatment of leases.

Credit risk exposures in the Insurance and Wealth division largely result from holding bond and loan assets, together with some related swaps, in the shareholder funds (including the annuity portfolio) and from exposure to reinsurers.

The investments held in the Group's defined benefit pension schemes also expose the Group to credit risk. Note 35 on page F-44 provides further information on the defined benefit pension schemes' assets and liabilities.

Loans and advances, contingent liabilities, commitments, debt securities and derivatives also expose the Group to refinance risk. Refinance risk is the possibility that an outstanding exposure cannot be repaid at its contractual maturity date. If the Group does not wish to refinance the exposure then there is refinance risk if the obligor is unable to repay by securing alternative finance. This may be because the borrower is in financial difficulty, because the terms required to refinance are outside acceptable appetite at the time or the customer is unable to refinance externally, due to a lack of market liquidity. Refinance risk exposures are managed in accordance with the Group's existing credit risk policies, processes and controls, and are not considered to be material given the Group's prudent and through the cycle credit risk appetite. Where heightened refinance risk exists (such as in Commercial Banking's Business Support Unit (BSU) or the run-off book) exposures are minimised through intensive account management and are impaired and identified as forborne where appropriate.

MEASUREMENT

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components:

(i) the 'probability of default' (PD) by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

Assessment of obligor quality for both retail and commercial counterparties is largely based on the outcomes of credit risk PD rating models. The Group operates a number of different regulatory rating models, typically developed internally using statistical analysis and management judgement – retail models rely more on the former, commercial models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data, where appropriate.

The models vary, inter alia, in the extent to which they are 'point in time' versus 'through the cycle'. The models are subject to rigorous validation and oversight and governance including, where appropriate, benchmarking to external information.

In the principal retail portfolios, exposure at default and loss given default models are in use. For regulatory reporting purposes, counterparties are segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty PD changes. The retail master scale comprises 13 non-default ratings and one default rating.

In commercial portfolios the PD models also segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities. Counterparties migrate between rating grades if the assessment of the PD changes. The corporate (non-retail) master scale comprises of 19 non-default ratings and 4 default rating grades, and forms the basis on which internal reporting is completed.

Use of internally modelled outputs in the regulatory capital process is specific to the calculation approach being used. Under the Retail Internal Ratings Based (IRB) approach the rating system PD assessment is used alongside calculated exposure at default and loss given default values in order to derive risk-weighted assets (RWAs) and regulatory Expected Loss (EL). The Foundation IRB approach requires the use of the rating system PD alongside regulatory prescribed exposure at default and loss given default values. Slotting portfolios do not use loss given default whilst Standardised requires the use of regulatory refined exposure at default in a defined RWA calculation.

Impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the regulatory EL models. Note 2(H) on page F-13 provides details of the Group's approach to the impairment of financial assets.

MITIGATION

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

Prudent, through the cycle credit principles, risk policies and appetite statements: The independent Risk division sets out the credit principles, credit risk policies and credit risk appetite statements. Principles and policies are reviewed regularly, and any changes are subject to an approval process. Policies and risk appetite statements, where appropriate, are supported by procedures, which provide a disciplined and focused benchmark for credit decisions. Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group, which includes tracking portfolio performance against an agreed set of credit risk appetite tolerances. Oversight and reviews are also undertaken by independent credit risk oversight functions and Group Internal Audit.

Strong models and controls: The independent Risk division has established a set of model risk management principles, designed to ensure models and associated rating systems are developed consistently and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating models are developed and owned by the Risk division. The designated model owner takes responsibility for ensuring the fitness for purpose of the rating systems, supported and challenged by the independent specialist Group function.

Limitations on concentration risk: There are portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual, customer and bank limit guidelines. Credit policies and appetite statements are aligned to the Group’s risk appetite and restrict exposure to higher risk countries and potentially vulnerable sectors and asset classes. Note 17 on page F-31 provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent both an excessive concentration of risk and single name concentrations. These concentration risk controls are not necessarily in the form of a maximum limit on exposure, but may instead require new business in concentrated sectors to fulfil additional minimum policy and/or guideline requirements. The Group’s largest exposures are regularly reported to the Board Risk Committee and reported in accordance with regulatory reporting requirements.

Robust country risk management: The Board sets a broad maximum country risk appetite. Within this, the Executive Credit Approval Committee approves the Group country risk framework and sovereign limits on an annual basis. Risk based country appetite for all countries is set within the independent Risk division, taking into account economic, financial, political and social factors as well as the approved business and strategic plans of the Group.

Specialist expertise: Credit quality is managed and controlled by a number of specialist units within the business and Risk division providing, for example: intensive management and control (see overleaf for Intensive care of customers in financial difficulty); security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.

Stress testing and scenario analysis: The Group's credit portfolios are also subjected to regular stress testing, with stress scenario assessments run at various levels of the organisation. Exercises focused on individual divisions and portfolios are performed in addition to the Group led and regulatory stress tests. For further information on stress testing process, methodology and governance, see page 48.

Frequent and robust credit risk oversight and assurance: Undertaken by independent credit risk oversight functions operating within Retail Credit Risk and Commercial Banking Risk which are part of the Group's second line of defence. Their primary objective is to provide reasonable and independent oversight that credit risk is being managed with appropriate and effective controls.

Group Internal Audit provides assurance to the Board Audit Committee on the effectiveness of credit risk management controls across the Group's activities. The team carries out independent risk based control audits across the full credit lifecycle.

Additional mitigation for Retail customers

The Group uses a variety of lending criteria when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using internal data and information held by Credit Reference Agencies (CRA).

The Group also assesses the affordability and sustainability of lending for each borrower; for secured lending this includes use of an appropriate stressed interest rate scenario. Affordability assessments are compliant with relevant regulatory conduct guidelines. The Group takes reasonable steps to validate information used in the assessment of a customer's income and expenditure.

In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are policy limits above which the Group will reject borrowing applications. The Group also applies certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

For UK Secured, the Group's policy permits owner occupier applications with a loan to value (LTV) maximum of 95 per cent. Applications with an LTV above 90 per cent are subject to enhanced underwriting criteria, including higher scorecard cut-offs.

Buy-to-let mortgages are limited to a maximum loan size of £1,000,000 and 75 per cent LTV. Buy-to-let applications must pass a minimum rental cover ratio of 125 per cent under stressed interest rates, after applicable tax liabilities. Since September 2017, Portfolio Landlords (customers with four or more mortgaged buy-to-let properties) have been subject to additional controls including evaluation of overall portfolio resilience.

The Group's policy is to reject any application for a lending product where a customer is registered as bankrupt or insolvent, or has a recent County Court Judgment or financial default registered at a CRA used by the Group above de minimis thresholds. In addition, the Group rejects applicants where total unsecured debt, debt-to-income ratios, or other indicators of financial difficulty exceed policy limits.

Where credit acceptance scorecards are used, new models, model changes and monitoring of model effectiveness are independently reviewed and approved in accordance with the governance framework set by the Group Model Governance Committee.

Additional mitigation for Commercial customers

Individual credit assessment and independent sanction of customer and bank limits: With the exception of small exposures to SME customers where relationship managers have limited delegated sanctioning authority, credit risk in commercial customer portfolios is subject to sanction by the independent Risk division, which considers the strengths and weaknesses of individual transactions, the balance of risk and reward, and how credit risk aligns to the Group's risk appetite. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities and limit guidelines. Approval requirements for each decision are based on a number of factors including, but not limited to, the transaction amount, the customer's aggregate facilities, credit policy, risk appetite, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty and customer underwriting is generally the same as that for assets intended to be held to maturity. All hard underwriting must be sanctioned via credit limits and a pre-approved credit matrix may be used for 'best efforts' underwriting.

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

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

Collateral

The principal collateral types acceptable for loans and advances, contingent liabilities and derivatives with commercial and bank counterparties and customers are:

– residential and commercial properties;

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

– financial instruments such as debt securities;

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– vehicles;

– cash; and

– guarantees received from third parties.

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

Collateral held as security for financial assets other than loans and advances is determined by the nature of the underlying exposure. Debt securities, including treasury and other bills, are generally unsecured, with the exception of asset-backed securities and similar instruments such as covered bonds, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, however securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with financial counterparties are typically collateralised under a Credit Support Annex (CSA) in conjunction with the International Swaps and Derivatives Association (ISDA) Master Agreement. Derivative transactions with non-financial customers are not usually supported by a CSA.

No collateral is held in respect of retail credit card or unsecured personal lending. For non-mortgage retail lending to small businesses, collateral may include second charges over residential property and the assignment of life cover.

Commercial lending decisions must be based on an obligor’s ability to repay from normal business operations rather than reliance on the disposal of any security provided. The requirement for collateral and the type to be taken at origination will be based upon the nature of the transaction and the credit quality, size and structure of the borrower. For non-retail exposures, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a debenture over one or more of the assets of a company or limited liability partnership, personal guarantees, limited in amount, from the directors of a company or limited liability partnership and key man insurance. The Group maintains policies setting out acceptable collateral bases for valuation, maximum LTV ratios and other criteria to be considered when reviewing an application. Other than for project finance, object finance and income producing real estate where charges over the subject assets are required, the provision of collateral will not determine the outcome of an application. Notwithstanding this, the fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay a customer or counterparty’s financial commitment.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor and type of underlying transaction. Although lending decisions are 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 and returns.

Collateral values are assessed at the time of loan origination. The Group requires collateral to be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. In certain circumstances, for Retail residential mortgages this may include the use of automated valuation models based on market data, subject to accuracy criteria and LTV limits. Collateral values are reviewed on a regular basis which will vary according to the type of lending, collateral involved and account performance. Such reviews are undertaken to confirm that the value recorded in the Bank's systems remains appropriate and whether revaluation is required, considering for example, account performance, market conditions and any information available that may indicate that the value of the collateral has materially declined. In such instances, the Group may seek additional collateral. For Retail, the Group adjusts open market values to take account of the costs of realisation and any discount associated with the realisation of the collateral when estimating credit losses.

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

The Group seeks to avoid correlation or wrong way risk where possible. Under repurchase (repo) policy, the issuer of the collateral and the repo counterparty should be neither the same nor connected. The same rule applies for derivatives. The Risk division has the necessary discretion to extend this rule to other cases where there is significant correlation. Countries with a rating equivalent to AA- and above may be considered to have no adverse correlation between the counterparty domiciled in the country and that country of risk (issuer of securities).

Refer to note 51 on page F-78 for further information on collateral.

Master netting agreements

It is credit policy that a Group approved master netting agreement must be used for all derivative and traded property transactions and must be in place prior to trading. Any exceptions must be approved by the credit sanctioner. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis, within relevant jurisdictions and for appropriate counterparty types they do reduce the credit risk to the extent that, if an event of default occurs, all trades with the counterparty may be terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since this is the net position of all trades under the master netting agreement.

Other credit risk transfers

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

MONITORING

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

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

Intensive care of customers in financial difficulty

The Group operates a number of solutions to assist borrowers who are experiencing financial stress. The material elements of these solutions through which the Group has granted a concession, whether temporarily or permanently, are set out below.

Retail customers

The Group's aim in offering forbearance and other assistance to customers in financial distress is to benefit both the customer and the Group by discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests and by bringing customer facilities back into a sustainable position which, for owner occupier mortgages, also means keeping customers in their homes. The Group offers a range of tools and assistance to support customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework, controls around the execution of policy, regular review of the different treatments to confirm that they remain appropriate, monitoring of customers' performance and the level of payments received, and management visibility of the nature and extent of assistance provided and the associated risk.

Assistance is provided through trained colleagues in branches and dedicated telephony units, and via online guidance material. For those customers requiring more intensive help, assistance is provided through dedicated support units where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies when they have multiple credit facilities, including those at other lenders that require restructuring. Within the collections and recoveries functions, the sharing of best practice and alignment of policies across the Group has helped to drive more effective customer outcomes and achieve operational efficiencies.

The specific tools available to assist customers vary by product and the customer's status. In defining the treatments offered to customers who have experienced financial distress, the Group distinguishes between the following categories:

- 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.

- Repair: a permanent account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

Forbearance identification, classification and measurement

The Group classifies Retail accounts 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. 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 may classify 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.

Those forborne loans which fall below individual assessment limits for impairment are grouped with other assets of similar characteristics and assessed collectively in accordance with the Group impairment policy detailed in note 2(H) on page F-13. The Group's approach is to ensure that provisioning models, supported by management judgement, appropriately reflect the underlying loss risk of exposures. The performance and output of models are monitored and challenged on an ongoing basis, in line with the Group's model governance policies.

The Group measures the success of a forbearance scheme for secured customers based upon the proportion of customers performing (less than or equal to three months in arrears) over the 24 months following the exit from a forbearance treatment. For temporary treatments, 80.7 per cent of customers accepting reduced payment arrangements are performing. For permanent treatments, 83.4 per cent of customers who have accepted capitalisations of arrears and 84.3 per cent of customers who have accepted term extensions are performing.

Customers receiving support from UK government sponsored programmes

To assist customers in financial distress, the Group also participates in UK government sponsored programmes for households the most significant of which is the Income Support for Mortgage Interest (SMI) which provides certain defined categories of customers access to a benefit scheme, paid for by the government, which covers all or part of the interest on the mortgage. There are two primary categories:

- Customers claiming Jobseeker's Allowance, Income Support, Universal Credit or Employment and Support Allowance benefits: Qualifying customers are able to claim for mortgage interest at 2.61 per cent on up to £200,000 of the mortgage. There is a two year time limit on Jobseeker's Allowance claims that started getting SMI benefit after 5 January 2009. There is no time limit for Income Support, Universal Credit or Employment and Support Allowance customer claims.

- Pension Credit customers: Qualifying customers are able to claim for mortgage interest at 2.61 per cent on up to £100,000 of the mortgage and there is no time limit as to how long they can claim.

For both categories, all decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the government. Payments are made directly to the Group by the Department of Work and Pensions. The Group estimates that customers representing approximately £1.6 billion of its mortgage exposures are receiving this benefit, including those who are also receiving other treatments for financial difficulty.

Commercial customers

Early identification, control and monitoring are key to supporting the customer and protecting the Group. With the exception of small exposures in SME all non-retail exposures in the Commercial Banking and Run-off divisions are reviewed at least annually (and more frequently where required) by the independent Risk division. As part of the Group's established credit risk classification system, every exposure in the good book is categorised as either 'good' or 'watchlist'. The term 'watchlist' refers to cases which require closer monitoring on the good book and are split between 'special mention' and 'special review' (the latter being the more serious of the two). This complements the Group's risk rating tools and is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. All watchlist names are reviewed by the business and Risk division regularly, and the classification is updated if required. This process seeks to ensure that relationship managers act promptly to identify, and highlight to senior management, those customers who have greater potential to become higher risk in the future.

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Those customers deemed higher risk where there is cause for concern over future repayment capability or where there is a risk of the asset becoming impaired will be transferred to the BSU at an early stage. The decision to transfer rests with the Credit teams and not the relationship team. On transfer, the BSU will take over the 'credit' responsibility for the customer relationship whilst the 'servicing' responsibility remains with the original relationship manager. The over-arching aim of the BSU is to provide support and work consensually with each customer to try and resolve the issues, restore the business to a financially viable position and thereby bring about a business turnaround. This may involve a combination of restructuring, work out strategies and other types of forbearance.

With the exception of small exposures (<£50,000) in SME, BSU case officers manage stressed and doubtful assets in Commercial Banking and are part of the independent Risk division. They are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and close scrutiny by senior management. Distressed run-off assets are managed to the same standards by Client Asset Management (CAM).

A detailed assessment is undertaken for cases in BSU to assist in reducing and minimising risk exposure and to also highlight potential strategic options. A range of information is required to fully appraise and understand the customer's business and cashflow (and therefore debt serviceability).

This may involve the Group, in addition to using its own internal sector experts, engaging professional advisers to perform asset valuations, strategic reviews and where applicable, independent business reviews. The assessment may also involve:

- critically assessing a customer's ability to effectively manage the business in a distressed situation where a turnaround needs to be delivered;
- analysis of market sector factors, i.e. products, customers, suppliers, pricing and margin issues;
- performance review of operational areas that should be considered in terms of current effectiveness and efficiency and scope for improvements;
- financial analysis to model plans and factor in potential sensitivities, vulnerabilities and upsides; and
- determining the most appropriate corporate and capital structure suitable for the work out strategy concerned.

The above assessment, monitoring and control processes continue throughout the period the case is managed within the BSU. All the analysis performed around cash flows is used to determine appropriate impairment provisions.

The level of Commercial Banking BSU gross loans and advances to customers reduced from £3.4 billion to £2.6 billion between 31 December 2016 and 31 December 2017. The net reduction of £0.8 billion in BSU managed lending in Commercial Banking was driven by returns to mainstream, disposals, write-offs and repayments.

The Group's treatment of loan renegotiations is included in the impairment policy in note 2(H) on page F-13 Income statement information set out in the credit risk tables is on an underlying basis (see note 4 on page F-18).

Forbearance

A key factor in determining whether the Group treats a commercial customer as forborne is the granting of a concession which is outside the Group's current risk appetite to a borrower who experiences, or is believed to be about to experience, financial difficulty. Where a concession is granted to a customer that is not in financial difficulty or the risk profile is considered within the Group's current risk appetite, the concession would not be considered to be an act of forbearance. The Group does not believe forbearance reporting is appropriate for derivatives, available for sale assets and 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 it is a trigger for the review of the customer's credit profile. If there is any concern over the future cash flows and/or the Group incurring a loss, then forborne loans will be classified as impaired in accordance with the Group's impairment policy. All impaired loans, including recoveries portfolios, are currently reported as forborne.

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. The Group expects to have unimpaired forborne assets within its portfolios, where default has been avoided, or when no longer considered impaired, although the majority of these cases will be managed in the BSU, where more intensive management and monitoring is available.

Unimpaired forborne assets are included in calculating the overall collective unidentified impairment provision, which uses the historical observed default rate and loss emergence period of the relevant portfolio as a whole as part of its calculation.

Whilst the material portfolios have been reviewed for forbearance, some non-retail loans and advances in the Commercial Banking and Run-off divisions have not been reviewed on the basis that the level of unimpaired forbearance is relatively immaterial, or because the concept of forbearance is not relevant. These include, but are not limited to, Lloyds Bank Commercial Finance Ltd and The Agricultural Mortgage Corporation Plc.

Types of forbearance

The Group's strategy and offer of forbearance is largely dependent on each customer's individual situation. Early identification, control and monitoring are key to supporting the customer and protecting the Group. Concessions are often provided to help the customer with their day-to-day liquidity and working capital. 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.

For commercial customers, the Group currently looks at forbearance concessions including changes to:

– Contractual payment terms (for example loan maturity extensions, or changes to capital and/or interest servicing arrangements, including capital repayment holidays or conversion to interest only terms); and

– Non-payment contractual terms (for example covenant amendments or waivers) where the concession enables default to be avoided.

The main types of forbearance concessions to commercial customers in or facing 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 and the customer is kept under review in the event that further forbearance is necessary;

– Extensions and 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 capital and/or interest servicing arrangements including capital repayment holidays or conversion to interest only terms; and

– Multiple type of forbearance (a combination of the above two).

Forbearance identification, classification and measurement

All non-retail loans and advances on the watchlist are 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 independent Risk function regularly and the classification is updated if required.

Any event that causes concern over future payments is likely to result in the customer being assessed for impairment and, if required, an impairment allowance recognised. If impairment is identified, the customer is immediately transferred to BSU (if not already managed there) and the lending will be treated as impaired.

All of a customer's impaired loans are treated as forborne as they are considered to have been (or will be) granted some form of forbearance. Most impaired loans and advances exist only in the BSU within Commercial Banking and Run-off divisions.

A portfolio approach is taken for SME customers with exposures below £1 million managed in BSU. All customers with exposures below £1 million are reported as forborne whilst they are managed by SME BSU (whether impaired or unimpaired).

All reviews performed in the good book, BSU within Commercial Banking or in the Run-off division 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 any forbearance concession that may have been provided.

Exit from forbearance

Where forbearance has been granted a customer will remain treated and recorded as forborne until the customer 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 cure period is currently expected to be at least 12 months following a forbearance event. Customers curing are managed according to their overriding credit risk classification categorisation; this could be in BSU, Run-off or in the mainstream good book.

The exception to this 12 month minimum period is where a permanent structural cure is made (for example, an injection of new collateral security or a partial repayment of debt to restore an LTV to within a covenant). In this case, the customer may exit forbearance once the permanent cure has been made.

Notwithstanding this, the overriding requirement for exit from forbearance in all cases is that the customer is not impaired and the reason for the forbearance event is no longer present.

Upon exit from forbearance the customer may be returned to the mainstream good classification. It is important to note that such a decision can be made only by the independent Risk division.

THE GROUP CREDIT RISK PORTFOLIO IN 2017

Overview

- Asset quality remains strong with portfolios continuing to benefit from the Group's proactive approach to risk management, continued low interest rates and a resilient UK economic environment.
- Gross impairment charges remain broadly flat, including the acquisition of MBNA.
- Gross asset quality ratio (excluding releases and write-backs) was stable at 28 basis points.
- The net impairment charge increased to £795 million in 2017 compared to £645 million in 2016, reflecting expected lower provision releases and write-backs and the acquisition of MBNA (£118 million). The net asset quality ratio for 2017 was 18 basis points (2016: 15 basis points).
- The Group expects an asset quality ratio of around 35 basis points through the cycle and less than 30 basis points through the plan period and in 2018.
- Impaired loans as a percentage of closing loans and advances reduced to 1.6 per cent (31 December 2016: 1.8 per cent) with impaired loans down £0.7 billion to £7.8 billion (31 December 2016: £8.5 billion), with reductions across Retail, Commercial Banking and Run-off divisions. As at 31 December Retail impaired loans were £104 million

lower at £4,951 million, despite including £151 million relating to the acquisition of MBNA. Commercial Banking impaired loans reduced by £270 million to £1,927 million, driven by impaired loan repayments and reductions, partly offset by a large newly impaired loan.

Low risk culture and prudent risk appetite

– The Group continues to take a prudent approach to credit risk, with robust credit quality and affordability controls at origination and a prudent through the cycle credit risk appetite. The Group's portfolios are well positioned against an uncertain economic outlook and potential market volatility.

– The Group continues to grow lending to key segments while maintaining prudent credit criteria.

– The Group's effective risk management ensures early identification and management of customers and counterparties who may be showing signs of distress.

– Sector concentrations within the lending portfolios are closely monitored and controlled, with mitigating actions taken where appropriate. Sector and product caps limit exposure to certain higher risk and vulnerable sectors and asset classes. In particular:

  – The average indexed LTV of the UK Retail mortgage portfolio improved to 43.6 per cent (31 December 2016: 44.0 per cent) and the percentage of Secured loans and advances with an indexed LTV greater than 100 per cent was 0.6 per cent (31 December 2016: 0.7 per cent). The average LTV for new UK Retail mortgages written in 2017 was 63.0 per cent (31 December 2016: 64.4 per cent).

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– The value of UK Retail mortgage lending with an indexed LTV of greater than 80 per cent fell to £30,680 million (31 December 2016: £32,395 million).

– Total UK Direct Real Estate gross lending across the Group was £17.9 billion at 31 December 2017 (31 December 2016: £19.9 billion) and includes Commercial Banking lending of £17.3 billion, and £0.2 billion within Retail Business Banking (within Retail). The Group's legacy run-off direct real estate portfolio has continued to fall and was £0.4 billion at 31 December 2017.

– Run-off net external assets stood at £9.1 billion at 31 December 2017, down from £11.3 billion at 31 December 2016. The portfolio represents only 1.8 per cent of the overall Group's loans and advances (31 December 2016: 2.1 per cent).

Table 1.4: Group impairment charge

2017	**Loans and advances to customers £m**	**Debt securities classified as loans and receivables £m**	**Available -for-sale financial assets £m**	**Other credit risk provisions £m**	**Total £m**	2016[1] £m
Retail	717	–	–	–	717	654
Commercial Banking	117	–	3	(5)	115	17
Insurance and Wealth	–	–	–	–	–	–
Run-off	(31)	(6)	–	(4)	(41)	(26)
Central items	1	–	3	–	4	–
Total impairment charge	804	(6)	6	(9)	795	645
Asset quality ratio					0.18%	0.15%
Gross asset quality ratio					0.28%	0.28%

1 Restated. See page F-18.

Table 1.5: Movement in gross impaired loans

	2017					
	Retail £m	**Commercial Banking £m**	**Insurance and Wealth £m**	**Run-off £m**	**Total £m**	2016 Total £m
At 1 January[1]	5,055	2,197	26	1,217	8,495	9,590
Classified as impaired during the year	2,342	637	9	101	3,089	3,154
Transferred to not impaired during the year	(783)	(132)	(8)	(67)	(990)	(1,047)

Repayments	(711)	(601)	(2)	(163)	(1,477)	(1,327)
Amounts written off	(1,073)	(136)	2	(133)	(1,340)	(1,472)
Impact of disposal of business and asset sales	(8)	–	–	(20)	(28)	(492)
Impact of acquisition of businesses	138	–	–	–	138	–
Exchange and other movements	(9)	(38)	1	–	(46)	89
At 31 December	4,951	1,927	28	935	7,841	8,495

1Restated. See page F-18.
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Table 1.6: Group impaired loans and provisions

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2017					
Retail	341,705	4,951	1.4	2,147	46.1
Commercial Banking	100,812	1,927	1.9	830	43.1
Insurance and Wealth	818	28	3.4	9	32.1
Run-off	8,533	935	11.0	456	48.8
Reverse repos and other items[3]	23,886				
Total gross lending	475,754	7,841	1.6	3,442	45.6
Impairment provisions	(3,442)				
Fair value adjustments[4]	186				
Total Group	472,498				
At 31 December 2016[5]					
Retail	332,953	5,055	1.5	2,011	42.9
Commercial Banking	102,398	2,197	2.1	828	37.7
Insurance and Wealth	812	26	3.2	11	42.3
Run-off	10,259	1,217	11.9	682	56.0
Reverse repos and other items[3]	15,249				
Total gross lending	461,671	8,495	1.8	3,532	43.4
Impairment provisions	(3,532)				
Fair value adjustments[4]	(181)				
Total Group	457,958				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries in Retail (31 December 2017: £291 million; 31 December 2016: £365 million).

3 Includes £6.9 billion (December 2016: £6.7 billion) of lower risk loans sold by Commercial Banking and Retail to Insurance and Wealth to back annuitant liabilities.

4 The Group made adjustments to reflect the HBOS and MBNA loans and advances at fair value on acquisition. At 31 December 2017, the remaining fair value adjustment was £186 million comprising a positive adjustment of £270 million in respect of the MBNA assets and a negative adjustment of £84 million in respect of the HBOS assets. The fair value unwind in respect of impairment losses incurred was £85 million for the year ended 31 December 2017 (31 December 2016: £70 million). The fair value adjustment in respect of loans and advances is expected to

continue to decrease in future years and will reduce to zero over time.

5 Restated. See page F-18.

Table 1.7: Derivative credit risk exposures

	2017				2016			
		Traded over the counter				Traded over the counter		
	Traded on recognised exchanges £m	**Settled by central counterparties £m**	**Not settled by central counterparties £m**	**Total £m**	Traded on recognised exchanges £m	Settled by central counterparties £m	Not settled by central counterparties £m	Total £m
Notional balances								
Foreign exchange	–	19	278,833	278,852	–	254	369,368	369,622
Interest rate	109,492	2,903,481	324,834	3,337,807	167,399	3,023,742	423,709	3,614,850
Equity and other	15,455	–	9,695	25,150	32,172	–	11,046	43,218
Credit	–	–	4,568	4,568	–	–	8,098	8,098
Total	124,947	2,903,500	617,930	3,646,377	199,571	3,023,996	812,221	4,035,788
Fair values								
Assets		280	25,155			262	35,563	
Liabilities		(592)	(25,454)			(1)	(34,506)	
Net asset		(312)	(299)			261	1,057	

The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2017 and 31 December 2016 is shown in the table above. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 51 on page F-78.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Retail

– Asset quality remains strong across all portfolios, with stable new business quality and flow of loans entering arrears.

– The impairment charge increased by £63 million to £717 million. Excluding MBNA, impairments were £55 million lower driven by a net release on the Secured portfolio, due to reduced impaired loans and rising house prices, which was offset by higher impairment charges on the Loans and UK Motor Finance portfolios.

– Impairment provisions as a percentage of impaired loans increased to 46.1 per cent from 42.9 per cent at the end of 2016.

Table 1.8: Retail impairment charge

	2017 £m	2016[1] £m	Change %
Secured	(15)	104	
Credit cards	254	136	(87)
Loans	111	70	(59)
Overdrafts	227	241	6
UK Motor Finance	111	75	(48)
Retail Business Banking	27	27	–
Europe	2	1	
Total impairment charge	717	654	(10)
Asset quality ratio	0.21 %	0.20 %	1bp

1 Restated. See page F-18.

Table 1.9: Retail impaired loans and provisions

	Loans and advances to customers £m	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans[2] %**
At 31 December 2017					

Secured	292,187	3,886	1.3	1,443	37.1
Credit cards	18,134	413	2.3	267	82.9
Loans	8,010	254	3.2	107	79.9
Overdrafts	1,595	197	12.4	113	86.3
UK Motor Finance	13,738	134	1.0	171	127.6
Retail Business Banking	928	24	2.6	23	230.0
Europe	7,113	43	0.6	23	53.5
Total gross lending	341,705	4,951	1.4	2,147	46.1
Impairment provisions	(2,147)				
Fair value adjustments	186				
Total	339,744				
At 31 December 2016[3]					
Secured	294,503	4,104	1.4	1,503	36.6
Credit cards	9,843	307	3.1	157	81.8
Loans	7,767	277	3.6	92	81.4
Overdrafts	1,952	179	9.2	90	82.6
UK Motor Finance	11,555	120	1.0	127	105.8
Retail Business Banking	1,004	27	2.7	22	200.0
Europe	6,329	41	0.6	20	48.8
Total gross lending	332,953	5,055	1.5	2,011	42.9
Impairment provisions	(2,011)				
Fair value adjustments	(181)				
Total	330,761				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries for Credit cards (31 December 2017: £91 million; 31 December 2016: £115 million), Loans (31 December 2017: £120 million; 31 December 2016: £164 million), Overdrafts (31 December 2017: £66 million; 31 December 2016: £70 million) and Retail Business Banking (31 December 2017: £14 million; 31 December 2016: £16 million).

3 Restated. See page F-18.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Secured

- Total loans and advances reduced by 0.8 per cent to £292,187 million (31 December 2016: £294,503 million). The closed Specialist portfolio has continued to run-off, reducing by 10.9 per cent to £15,668 million.

- New business quality remained stable and early arrears have continued to reduce.

- The value of mortgages greater than three months in arrears (excluding repossessions) reduced to £5,437 million at 31 December 2017 (31 December 2016: £6,033 million).

- Impaired loans decreased by £218 million to £3,886 million (31 December 2016: £4,104 million), and impaired loans as a percentage of closing advances reduced to 1.3 per cent (31 December 2016: 1.4 per cent).

- UK house prices increased by 2.7 per cent over 2017 (on a quarterly non-seasonally adjusted basis).

  - The average indexed LTV of the portfolio improved to 43.6 per cent (31 December 2016: 44.0 per cent).

  - The value of lending with an indexed LTV of greater than 80 per cent fell to £30,680 million (31 December 2016: £32,395 million).

  - The percentage of loans and advances with an indexed LTV in excess of 100 per cent fell to 0.6 per cent (31 December 2016: 0.7 per cent).

  - The average LTV for new mortgages written in 2017 was 63.0 per cent (31 December 2016: 64.4 per cent).

- Net impairment release of £15 million in 2017 (2016: £104 million charge) reflects an improvement in the level of impaired loans in the portfolio.

- Impairment provisions as a percentage of impaired loans increased to 37.1 per cent (31 December 2016: 36.6 per cent), reflecting the continued prudent approach to provisioning.

Table 1.10: Retail secured loans and advances to customers

	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Mainstream	223,322	222,450
Buy-to-let	53,197	54,460
Specialist	15,668	17,593

Total secured	292,187	294,503

Table 1.11: Mortgages greater than three months in arrears (excluding repossessions)

	Number of cases		**Total mortgage accounts %**		**Value of loans**[1]		**Total mortgage balances %**	
	2017	2016	**2017**	2016	**2017**	2016	**2017**	2016
at 31 Dec	**Cases**	Cases	**%**	%	**£m**	£m	**%**	%
Mainstream	32,383	35,254	1.6	1.7	3,502	3,865	1.6	1.7
Buy-to-let	4,710	5,324	1.0	1.1	581	660	1.1	1.2
Specialist	8,313	9,078	7.3	7.2	1,354	1,508	8.7	8.6
Total	45,406	49,656	1.7	1.8	5,437	6,033	1.9	2.0

1 Value of loans represents total gross book value of mortgages more than three months in arrears.

The stock of repossessions increased to 777 cases at 31 December 2017 compared to 678 cases at 31 December 2016.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.12: Period end and average LTVs across the Retail mortgage portfolios

	Mainstream %	**Buy-to-let** %	**Specialist** %	**Total** %	**Unimpaired** %	**Impaired** %
At 31 December 2017						
Less than 60%	57.1	53.9	57.6	56.4	56.7	41.7
60% to 70%	16.9	25.0	18.4	18.5	18.5	18.6
70% to 80%	14.5	15.7	12.8	14.6	14.6	14.6
80% to 90%	9.0	4.1	6.4	8.0	7.9	10.5
90% to 100%	2.1	0.7	1.6	1.9	1.8	5.3
Greater than 100%	0.4	0.6	3.2	0.6	0.5	9.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	223,322	53,197	15,668	292,187	288,301	3,886
Average loan to value[1]:						
Stock of residential mortgages	41.7	53.0	47.4	43.6		
New residential lending	63.7	59.1	**n/a**	63.0		
Impaired mortgages	50.0	68.3	60.4	54.1		
At 31 December 2016						
Less than 60%	56.8	52.0	53.8	55.8	56.0	38.3
60% to 70%	17.8	25.4	17.8	19.2	19.3	18.4
70% to 80%	14.0	14.4	13.6	14.0	14.0	15.3
80% to 90%	8.4	6.1	8.6	8.0	7.9	11.9
90% to 100%	2.4	1.5	3.1	2.3	2.2	6.8
Greater than 100%	0.6	0.6	3.1	0.7	0.6	9.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	222,450	54,460	17,593	294,503	290,399	4,104
Average loan to value[1]:						
Stock of residential mortgages	41.8	53.7	49.2	44.0		
New residential lending	65.0	61.9	n/a	64.4		
Impaired mortgages	51.8	69.0	61.9	55.8		

1 Average loan to value is calculated as total loans and advances as a percentage of the total indexed collateral of these loans and advances.

Interest only mortgages

The Group provides interest only mortgages to owner occupier mortgage customers whereby only payments of interest are made for the term of the mortgage with the customer responsible for repaying the principal outstanding at the end of the loan term. At 31 December 2017, owner occupier interest only balances as a proportion of total owner occupier balances had reduced to 29.2 per cent (31 December 2016: 31.8 per cent). The average indexed loan to value improved to 41.7 per cent (31 December 2016: 42.6 per cent).

For existing interest only mortgages, a contact strategy is in place throughout the term of the mortgage to ensure that customers are aware of their obligations to repay the principal upon maturity of the loan.

Treatment strategies are in place to help customers anticipate and plan for repayment of capital at maturity and support those who may have difficulty in repaying the principal amount. A dedicated specialist team supports customers who have passed their contractual maturity date and are unable to fully repay the principal. A range of treatments are offered such as full (or part) conversion to capital repayment, and extension of term to match the maturity dates of any associated repayment vehicles.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.13: Analysis of owner occupier interest only mortgages

	2017	2016[1]
Interest only balances (£m)	69,703	76,229
Of which, impaired (%)	3.0	3.0
Average loan to value (%)	41.7	42.6
Maturity profile (£m):		
Due	1,093	1,028
1 year	2,672	2,499
2-5 years	10,227	10,287
6-10 years	18,026	17,368
>11 years	37,685	45,047
Past term interest only balances (£m)[2]	1,553	1,365
Of which, impaired (%)	13.1	11.7
Average loan to value (%)	33.4	31.5
Negative equity (%)	2.1	1.6

1 2016 values have been restated to include Scottish Widows Bank Mortgages and certain other interest only balances of £3,578 million.

2 Balances where all interest only elements have moved past term. Some may subsequently have had a term extension, so are no longer classed as due.

Credit cards

- Loans and advances increased by 84.2 per cent to £18,134 million (31 December 2016: £9,843 million), of which £8,003 million relates to MBNA. The MBNA portfolio is performing broadly in line with both the Group's expectations and the existing credit card portfolio.

- Impaired loans increased by £106 million to £413 million (31 December 2016: £307 million), of which £151 million related to MBNA. Impaired loans as a percentage of closing loans and advances improved to 2.3 per cent (31 December 2016: 3.1 per cent), reflecting good credit performance and the continued sale of debt in recoveries.

- The impairment charge increased to £254 million (2016: £136 million), driven by the acquisition of MBNA (£118 million).

Loans

- Loans and advances increased by 3.1 per cent to £8,010 million (31 December 2016: £7,767 million).
- Impaired loans decreased by £23 million to £254 million (31 December 2016: £277 million), largely due to the sale of debt in recoveries. Impaired loans as a percentage of closing loans and advances improved to 3.2 per cent (31 December 2016: 3.6 per cent).
- The impairment charge increased to £111 million (2016: £70 million), reflecting a one-off change relating to policy alignment across brands for franchised customers, and reducing cash flows due to previous sales of debt in recoveries.

Overdrafts

- Loans and advances decreased to £1,595 million (31 December 2016: £1,952 million).
- Impaired loans increased by £18 million to £197 million (31 December 2016: £179 million), and impaired loans as a percentage of closing advances increased to 12.4 per cent (31 December 2016: 9.2 per cent), reflecting a one-off impact relating to changes in overdraft fees and charges.
- The impairment charge decreased by 5.8 per cent to £227 million (2016: £241 million), largely due to increased sale of debt in recoveries and improved underlying performance.

UK Motor Finance

- Loans and advances increased by £2,183 million to £13,738 million (31 December 2016: £11,555 million), with 49.7 per cent of growth from Jaguar Land Rover business. The book continues to benefit from conservative residual values and prudent provisioning with stable credit quality and flows into arrears.
- Impaired loans increased by £14 million to £134 million (31 December 2016: £120 million), reflecting growth in the portfolio. Impaired loans as a percentage of closing loans and advances were stable at 1.0 per cent.
- The impairment charge increased by £36 million to £111 million (2016: £75 million), driven by portfolio growth and increased provisions for residual value risks reflecting a more conservative outlook on used car prices.

Forborne loans

Forborne loans and advances on the principal Retail portfolios reduced by £601 million in 2017 to £1,951 million, driven by improvements on the Secured portfolio. As a percentage of loans and advances, forborne loans and advances on these portfolios improved to 0.6 per cent (31 December 2016: 0.8 per cent).

Impairment provisions as a percentage of loans and advances that are forborne increased to 13.0 per cent (31 December 2016: 9.6 per cent).

Secured forborne loans and advances reduced by £668 million in 2017 to £1,428 million, primarily due to a reduction in recapitalisations (with historically higher levels of cases exiting the two year probation period) and a reduction in the level of reduced payment arrangements.

Within the other portfolios, movements were seen in the level of forborne loans and advances in relation to one off changes for 2017. This included the acquisition of MBNA in the Credit cards portfolio (with forborne loans and advances of £112 million and impaired forborne loans and advances of £90 million), and improved customer views and the reclassification of some treatments across the Loans and UK Motor Finance portfolios.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.14: UK Retail forborne loans and advances (audited)[1]

	Total loans and advances which are forborne		Total forborne loans and advances which are impaired		Impairment provisions as a % of loans and advances which are forborne	
	At Dec 2017 £m	At Dec 2016 £m	**At Dec 2017 £m**	At Dec 2016 £m	**At Dec 2017 %**	At Dec 2016 %
Temporary reduced payment arrangements	249	428	76	101	5.7	4.9
Permanent term extensions and repair	1,179	1,668	61	116	4.0	4.7
Secured	1,428	2,096	137	217	4.3	4.7
Credit cards	295	212	190	119	36.0	29.0
Loans[2]	86	49	45	46	27.9	44.4
Overdrafts	108	78	94	61	47.0	38.0
UK Motor Finance[2]	34	117	19	62	36.6	27.0
Total	1,951	2,552	485	505	13.0	9.6

1 Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last three months for Secured, and six months for other portfolios. Permanent changes, such as refinancing or recapitalisation which commenced during the last 24 months, are also included.

2 Figures for 2017 include improved customer views and the reclassification of some treatments.

The movements in Retail forborne loans and advances during the year are as follows:

Table 1.15: Movement in UK Retail forborne loans and advances (audited)

	2017					
	Secured £m	**Credit cards £m**	**Loans £m**	**Overdrafts £m**	**UK Motor Finance £m**	**Total £m**
At 1 January	2,096	212	49	78	117	2,552

Classified as forborne during the year	744	159	44	85	24	1,056
Written-off/sold	(13)	(100)	(18)	(32)	(20)	(183)
Exit from forbearance	(1,217)	(41)	(3)	(19)	(15)	(1,295)
Redeemed or repaid	(162)	(15)	(6)	–	(8)	(191)
Exchange and other movements[1]	(20)	80	20	(4)	(64)	12
At 31 December	1,428	295	86	108	34	1,951

	2016					
	Secured £m	Credit cards £m	Loans £m	Overdrafts £m	UK Motor Finance £m	Total £m
At 1 January	3,102	225	60	87	100	3,574
Classified as forborne during the year	975	110	34	50	82	1,251
Written-off/sold	(12)	(46)	(24)	(31)	(16)	(129)
Exit from forbearance	(1,741)	(43)	(4)	(24)	(22)	(1,834)
Redeemed or repaid	(200)	(9)	(6)	–	(16)	(231)
Exchange and other movements	(28)	(25)	(11)	(4)	(11)	(79)
At 31 December	2,096	212	49	78	117	2,552

1 Exchange and other movements for 2017 reflects the acquisition of MBNA within Credit cards, and improved customer views and the reclassification of some treatments across the Loans and UK Motor Finance portfolios.

Commercial Banking

- Net impairment charge was £115 million in 2017 (2016: £17 million) with the increase due to a lower level of write-backs and provision releases rather than a deterioration in the underlying portfolio.

- Both 2016 and 2017 included material charges against a single customer (2016: oil & gas sector, 2017: construction sector), but otherwise gross charges have remained relatively low.

- The portfolio continues to benefit from effective risk management, a resilient economic environment and continued low interest rates.

- Credit quality of the portfolio and new business remains generally good and the Group is not relaxing risk appetite despite a more competitive market.

- Impaired loans reduced by 12 per cent to £1,927 million at 31 December 2017 compared with £2,197 million at 31 December 2016, driven by impaired loan repayments and reductions, partly offset by a large newly impaired loan. Impaired loans as a percentage of closing loans and advances reduced to 1.9 per cent from 2.1 per cent at 31 December 2016.

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- Impairment provisions were broadly flat at £830 million at 31 December 2017 (31 December 2016: £828 million) and includes collective unidentified impairment provisions of £183 million (31 December 2016: £183 million). Provisions as a percentage of impaired loans increased from 37.7 per cent to 43.1 per cent during 2017, driven by a number of isolated cases.

- An uncertain UK and global economic outlook and uncertainty relating to EU exit negotiations have the ability to impact the Commercial Banking portfolios.

- Internal and external key performance indicators continue to be monitored closely to help identify early signs of any deterioration and portfolios remain subject to ongoing risk mitigation actions as appropriate.

- Despite the uncertain economic outlook, the portfolios are well positioned and the Group's through the cycle risk appetite approach is unchanged. Monitoring indicates no material deterioration in the credit quality of the Group's portfolios. Notwithstanding this, impairments are likely to increase from their historic low levels, driven mainly by lower levels of releases and write-backs and an element of credit normalisation.

Table 1.16: Commercial Banking impairment charge

	2017	2016[1]	Change
	£m	£m	%
SME	7	(7)	
Other	108	24	
Total impairment charge	115	17	
Asset quality ratio[2]	0.12%	0.02%	10bp

1 Restated. See page F-18.

2 In respect of loans and advances to customers.

Table 1.17: Commercial Banking impaired loans and provisions

	Loans and advances to customers £m	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans %**
At 31 December 2017					

SME	30,480	821	2.7	151	18.4
Other	70,332	1,106	1.6	679	61.4
Total gross lending	100,812	1,927	1.9	830	43.1
Impairment provisions	(830)				
Total	99,982				
At 31 December 2016[2]					
SME	29,959	923	3.1	173	18.7
Other	72,439	1,274	1.8	655	51.4
Total gross lending	102,398	2,197	2.1	828	37.7
Impairment provisions	(828)				
Total	101,570				

1 Impairment provisions include collective unidentified impairment provisions.

2 Restated. See page F-18.

Portfolios

– The SME Banking portfolio continues to grow within prudent credit risk appetite parameters. As a result of the Group's customer driven relationship management, net lending has increased 2 per cent in 2017. Portfolio credit quality has remained stable or improved across the majority of key risk metrics.

– The Mid Markets portfolio is domestically focused and reflects the underlying performance of the UK economy and the Group's prudent credit risk appetite. Credit quality has been stable with levels of financial stress and impairment remaining low.

– The Global Corporates business continues to have a predominance of investment grade clients, primarily UK based. The portfolio remains of good quality despite the current global economic uncertainty particularly relating to the EU Exit and a softer outlook in a number of sectors, including construction and retail.

– The commercial real estate business within the Group's Mid Markets and Global Corporate portfolio is focused on clients operating in the UK commercial property market ranging in size from medium-sized private real estate entities up to publicly listed property companies. The market for UK real estate has continued to be resilient, with appetite from a range of investors. UK real estate continues to offer attractive yields compared to other asset classes and the fall in Sterling has boosted the attractiveness to foreign investors. Credit quality remains good with minimal impairments/stressed loans. Recognising this is a cyclical sector, appropriate caps are in place to control exposure and business propositions continue to be written in line with a prudent, through the cycle risk appetite with conservative LTVs, strong quality of income and proven management teams.

– Through clearly defined sector strategies Financial Institutions serves predominantly investment grade counterparties with whom relationships are either client focused or held to support the Group's funding, liquidity or general hedging requirements. The portfolio continues to be prudently managed within the Group's conservative risk appetite and clearly defined sector strategies.

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– The Group continues to adopt a conservative stance across the Eurozone maintaining close portfolio scrutiny and oversight particularly given the current macro environment and horizon risks.

Commercial Banking UK Direct Real Estate LTV analysis

– The Group classifies Direct Real Estate as exposure which is directly supported by cash flows from property activities (as opposed to trading activities, such as hotels, care homes and housebuilders).

– Focus remains on the UK market, on good quality customers, with a proven track record in Real Estate and where cash flows are robust.

– Commercial Banking UK Direct Real Estate gross lending stood at £17.3 billion at 31 December 2017.

– Approximately 70 per cent of loans and advances to UK Direct Real Estate relate to commercial real estate with the remainder relating to residential real estate. The portfolio continues to be heavily weighted towards investment real estate (c.90 per cent) over development.

– The LTV profile of the UK Direct Real Estate portfolio in Commercial Banking continues to improve.

Table 1.18: LTV – UK Direct Real Estate

	At 31 December 2017[1]				At 31 December 2016[1]			
	Unimpaired	**Impaired**	**Total**		Unimpaired	Impaired	Total	
	£m	**£m**	**£m**	**%**	£m	£m	£m	%
UK Exposures > £5m								
Less than 60%	5,567	–	5,567	77.8	5,721	14	5,735	67.2
60% to 70%	855	–	855	12.0	1,470	–	1,470	17.2
70% to 80%	183	25	208	2.9	506	9	515	6.1
80% to 100%	14	54	68	1.0	20	6	26	0.3
100% to 120%	–	–	–	–	–	–	–	–
120% to 140%	–	–	–	–	–	–	–	–
Greater than 140%	–	49	49	0.7	–	68	68	0.8
Unsecured[2]	404	–	404	5.6	689	26	715	8.4
	7,023	128	7,151	100.0	8,406	123	8,529	100.0
UK Exposures <£5m[3]	9,443	305	9,748		9,563	429	9,992	
Total	16,466	433	16,899		17,969	552	18,521	

1 Excludes Islands Commercial UK Direct Real Estate of £0.4 billion (31 December 2016: £0.5 billion).

2 Predominantly investment grade corporate CRE lending where the Group is relying on the corporate covenant.

3 December 2017 <£5m exposures include £9.2 billion within SME which has an LTV profile broadly similar to the >£5m exposures.

Forborne loans

Commercial Banking forbearance

At 31 December 2017, £2,374 million (31 December 2016: £2,663 million) of total loans and advances were forborne of which £1,927 million (31 December 2016: £2,197 million) were impaired. Impairment provisions as a percentage of forborne loans and advances increased from 31.1 per cent at 31 December 2016 to 35.0 per cent at 31 December 2017.

Table 1.19: Commercial Banking forborne loans and advances (audited)

	Total loans and advances which are forborne		**Impairment provisions as a % of loans and advances which are forborne**	
	2017	2016[1]	**2017**	2016[1]
	£m	£m	**%**	%
Impaired	1,927	2,197	43.1	37.7
Unimpaired	447	466	–	–
Total	2,374	2,663	35.0	31.1

1 Restated. See page F-18.

All Commercial Banking impaired assets are considered forborne.

Impaired loans and advances

The movements in Commercial Banking impaired forborne loans and advances were as follows:

Table 1.20: Movement in Commercial Banking impaired forborne loans and advances (audited)

	2017	2016[1]
	£m	£m
At 1 January	2,197	2,543
Classified as impaired during the year		
Exposures >£5m	518	547
Exposures <£5m	119	124
	637	671
Transferred to unimpaired		
Exposures >£5m but still reported as forborne	–	–
Exposures >£5m no longer reported as forborne	(51)	(31)
Exposures <£5m	(81)	(81)
	(132)	(112)
Written-off	(136)	(311)
Asset disposals/sales of impaired assets	–	(33)
Drawdowns/repayments	(601)	(595)
Exchange and other movements	(38)	34
At 31 December	1,927	2,197

1 Restated. See page F-18.

Unimpaired loans and advances

Unimpaired forborne loans and advances were £447 million at 31 December 2017 (31 December 2016: £466 million).

The table below sets out the largest unimpaired forborne loans and advances to Commercial Banking customers (exposures over £5 million) as at 31 December 2017 by type of forbearance:

Table 1.21: Commercial Banking unimpaired forborne loans and advances[1] (audited)

	31 Dec 2017 £m	31 Dec 2016 £m
Type of unimpaired forbearance		
Exposures >£5m		
Covenants	157	153
Extensions/alterations	–	7
Multiple	–	21
	157	181
Exposures <£5m	290	285
Total	447	466

1 Material portfolios only.

Table 1.22: Movement in Commercial Banking unimpaired forborne loans and advances >£5m[1] (audited)

	2017 £m	2016 £m
At 1 January	181	669
Classified as impaired during the year	(34)	(63)
Cured no longer forborne	(50)	(413)
Classified as forborne during the tear	90	88
Transferred from impaired but still reported as forborne	–	–
Asset disposal/sales	–	–
Net drawdowns/repayments	(25)	(100)
Exchange and other movements	(5)	–
At 31 December	157	181

1 Balances exclude intra-year movements.

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Run-off

Table 1.23: Run-off impairment charge

	2017 £m	2016 £m	Change %
Ireland	(9)	(14)	36
Corporate real estate and other corporate	(13)	1	
Specialist finance	(15)	(2)	
Other	(4)	(11)	64
Total	(41)	(26)	(58)
Asset quality ratio[1]	(0.32%)	(0.15%)	(17)bp

1 In respect of loans and advances to customers.

Table 1.24: Run-off impaired loans and provisions

	Loans and advances to customers £m	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions £m**	**Impairment provisions as a % of impaired loans %**
At 31 December 2017					
Ireland	4,391	136	3.1	115	84.6
Corporate real estate and other corporate	815	692	84.9	287	41.5
Specialist finance	2,327	23	1.0	29	126.1
Other	1,000	84	8.4	25	29.8
Total gross lending	8,533	935	11.0	456	48.8
Impairment provisions	(456)				
Total	8,077				
At 31 December 2016					
Ireland	4,498	139	3.1	133	95.7
Corporate real estate and other corporate	1,190	896	75.3	399	44.5
Specialist finance	3,374	99	2.9	111	112.1
Other	1,197	83	6.9	39	47.0
Total gross lending	10,259	1,217	11.9	682	56.0

Impairment provisions	(682)
Total	9,577

EUROZONE EXPOSURES

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2017. The exposures comprise on balance sheet exposures based on their balance sheet carrying values net of provisions and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

The Group manages its exposures to individual countries through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected countries by establishing and monitoring risk limits for individual banks, financial institutions, corporates and individuals.

Identified indirect exposure information, where available, is also taken into account when setting limits and determining credit risk appetite for individual counterparties. This forms part of the Group's credit analysis undertaken at least annually for counterparty and sector reviews, with interim updates performed as necessary. Interim updates would usually be triggered by specific credit events such as rating downgrades, sovereign events or other developments such as spread widening. Examples of indirect risk which have been identified, where information is available, are: European banking groups with lending and other exposures to certain Eurozone countries; corporate customers with operations or significant trade in certain European jurisdictions; major travel operators known to operate in certain Eurozone countries; and international banks with custodian operations based in certain European locations.

The Chief Security Office (formerly the Group Financial Stability Forum) monitors developments within the Eurozone, carries out stress testing through detailed scenario analysis and completes appropriate due diligence on the Group's exposures. The Group has pre-determined action plans that would be executed in certain scenarios which set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications, suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

Derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level and net of cash collateral in line with legal agreements. Exposures in respect of reverse repurchase agreements are included on a gross International Financial Reporting Standards (IFRS) basis and are disclosed based on the counterparty rather than the collateral (repos and stock

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lending are excluded); reverse repurchase exposures are not, therefore, reduced as a result of collateral held. Exposures to central clearing counterparties are shown net.

For multi-country asset backed securities exposures, the Group has reported exposures based on the largest country exposure. The country of exposure for asset backed securities is based on the location of the underlying assets which are predominantly residential mortgages not on the domicile of the issuer.

For Insurance, the Group has reported shareholder exposures i.e. where the Group is directly exposed to risk of loss. These shareholder exposures relate to direct investments where the issuer is resident in the named Eurozone country and the credit rating is consistent with the tight credit criteria defined under the appropriate investment mandate. Insurance also has interests in funds domiciled in Ireland and Luxembourg where, in line with the investment mandates, cash is invested in short term financial instruments. The exposure is analysed on a look through basis to the country of risk of the obligors of the underlying assets rather than treating as exposure to country of domicile of the fund.

Exposures to selected Eurozone countries

The Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries.

Table 1.25: Selected Eurozone exposures

	Sovereign debt		**Financial Institutions**						
	Direct Sovereign Exposures £m	**Cash at Central Banks £m**	**Banks £m**	**Other[1] £m**	**Asset backed securities £m**	**Corporate £m**	**Personal £m**	**Insurance Assets[1] £m**	**Total £m**
At 31 December 2017									
Ireland	–	–	177	300	100	749	4,276	–	5,602
Spain	–	–	103	4	–	591	51	68	817
Portugal	–	–	5	–	–	9	7	–	21
Italy	–	–	33	–	–	78	–	99	210
Greece	–	–	–	–	–	–	–	–	–
	–	–	318	304	100	1,427	4,334	167	6,650

At 31 December 2016									
Ireland	–	–	215	512	91	929	4,363	–	6,110
Spain	23	–	76	126	–	630	41	19	915
Portugal	–	–	7	–	–	22	7	–	36
Italy	–	–	38	–	–	59	–	67	164
Greece	–	–	–	–	–	–	–	–	–
	23	–	336	638	91	1,640	4,411	86	7,225

[1] Excludes reverse repurchase exposure to Institutional funds domiciled in Ireland secured by UK gilts of £16,323 million (2016: £14,506 million) on a gross basis.

In addition to the exposures detailed above, the Group has exposures in the following Eurozone countries:

Table 1.26: Other Eurozone exposures

	Sovereign debt		**Financial Institutions**						
	Direct Sovereign Expenses £m	**Cash at Central Banks £m**	**Banks £m**	**Other[1] £m**	**Asset backed securities £m**	**Corporate £m**	**Personal £m**	**Insurance Assets £m**	**Total £m**
At 31 December 2017									
Netherlands	38	12,182	269	303	29	1,678	6,673	433	21,605
France	205	–	1,059	128	–	2,040	91	1,142	4,665
Germany	2,008	68	325	–	261	1,581	575	473	5,291
Luxembourg	22	–	306	702	629	1,130	–	4	2,793
Belgium	22	–	142	7	–	110	–	113	394
All other Eurozone countries	80	–	22	–	–	423	–	58	583
	2,375	12,250	2,123	1,140	919	6,962	7,339	2,223	35,331
At 31 December 2016									
Netherlands	–	8,795	343	324	50	1,610	6,315	423	17,860
France	–	–	1,907	620	41	2,648	96	851	6,163
Germany	1,543	93	538	31	224	1,598	443	477	4,947
Luxembourg	7	–	306	1,484	619	923	–	–	3,339
Belgium	35	–	1,009	300	–	114	–	49	1,507
All other Eurozone countries	38	–	95	–	–	354	–	62	549
	1,623	8,888	4,198	2,759	934	7,247	6,854	1,862	34,365

[1] Excludes reverse repurchase exposure to Institutional funds secured by UK gilts of £2,644 million (2016: £2,679 million) on a gross basis.

Environmental risk management

The Group ensures appropriate management of the environmental impact, including climate change, of its lending activities. The Group-wide credit risk principles require all credit risk to be incurred with due regard to environmental legislation and the Group's code of responsibility.

The Group's divisions are each exposed to different types and levels of climate-related risk in their operations. For example, the general insurance division regularly uses weather, climate and environmental models and data to assess its insurance risk from covered perils such as windstorm and flood. A team of specialist scientists are employed within underwriting to do this work and they also regularly monitor the state of climate science to assess the need to include its potential impacts within pricing and solvency. In response to the Task Force on Climate-related Financial Disclosure recommendations, in 2018 the Group will commence a systematic review of climate-related risks and opportunities across the Group's core divisions.

The Group has been a signatory to the Equator Principles since 2008 and has adopted and applied the expanded scope of Equator Principles III. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in Project Finance, Project-Related Corporate loans and Bridge loans. The Group has also been a signatory to the UN Principles for Responsible Investment (UNPRI) since 2012, which incorporate ESG (environmental, social and governance risk) considerations in asset management. Scottish Widows is responsible for the annual UNPRI reporting process.

Within Commercial Banking, an electronic Environmental Risk Screening Tool is the primary mechanism for assessing environmental risk for lending transactions. This system provides screening of location specific and sector based risks that may be present in a transaction. Where a risk is identified, the transaction is referred to the Group's expert in-house environmental risk team for further review and assessment, as outlined below. Where required, the Group's panel of environmental consultants provide additional expert support.

The Group provides colleague training on environmental risk management as part of the standard suite of Commercial Banking credit risk courses. To support this training, a range of online resource is available to colleagues and includes environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

Table 1.27: Environmental risk management approach

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LOAN PORTFOLIO

ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

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

	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Loans and advances to banks	6,611	26,902	25,117	26,155	25,365
Loans and advances to customers:					
Mortgages	304,665	306,682	312,877	333,318	335,611
Other personal lending	28,757	20,761	20,579	23,123	23,230
Agriculture, forestry and fishing	7,461	7,269	6,924	6,586	6,051
Energy and water supply	1,609	2,320	3,247	3,853	4,414
Manufacturing	7,886	7,285	5,953	6,000	7,650
Construction	4,428	4,535	4,952	6,425	7,024
Transport, distribution and hotels	14,074	13,320	13,526	15,112	22,294
Postal and telecommunications	2,148	2,564	2,563	2,624	2,364
Financial, business and other services	57,006	49,197	43,072	44,979	42,478
Property companies	30,980	32,192	32,228	36,682	44,277
Lease financing	2,094	2,628	2,751	3,013	4,435
Hire purchase	13,591	11,617	9,536	7,403	5,090
Total loans	481,310	487,272	483,325	515,273	530,283
Allowance for impairment losses	(2,201)	(2,412)	(3,033)	(6,414)	(11,966)
Total loans and advances net of allowance for impairment losses	479,109	484,860	480,292	508,859	518,317

Following the reduction in the Group’s non-UK activities, an analysis between domestic and foreign operations is not provided.

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SUMMARY OF LOAN LOSS EXPERIENCE

The following table analyses the movements in the allowance for impairment losses on loans and advances to banks and customers for each of the five years listed.

	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Balance at beginning of year	2,412	3,033	6,414	11,966	15,253
Exchange and other adjustments	132	69	(246)	(410)	291
Disposal of businesses	–	–	(82)	–	(176)
Advances written off:					
Loans and advances to customers:					
Mortgages	(42)	(42)	(71)	(87)	(601)
Other personal lending	(925)	(728)	(853)	(1,329)	(1,437)
Agriculture, forestry and fishing	(1)	(1)	(1)	(8)	(11)
Energy and water supply	–	(9)	(73)	–	(102)
Manufacturing	(40)	(19)	(126)	(59)	(130)
Construction	(65)	(96)	(21)	(157)	(84)
Transport, distribution and hotels	(65)	(64)	(728)	(1,119)	(798)
Postal and telecommunications	–	(189)	(11)	–	(14)
Financial, business and other services	(158)	(712)	(604)	(946)	(1,030)
Property companies	(136)	(215)	(1,648)	(2,669)	(1,891)
Lease financing	(2)	–	(31)	(4)	(10)
Hire purchase	(65)	(36)	(37)	(54)	(121)
Loans and advances to banks	–	–	–	–	(3)
Total advances written off	(1,499)	(2,111)	(4,204)	(6,432)	(6,232)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	17	44	35	18	28
Other personal lending	419	329	366	600	408
Energy and water supply	–	3	5	–	–
Manufacturing	–	80	–	–	–
Construction	4	78	–	–	–
Transport, distribution and hotels	15	50	63	–	–
Financial, business and other services	6	241	193	–	–
Property companies	–	34	101	–	–
Lease financing	19	–	–	–	–
Hire purchase	2	2	1	63	20
Total recoveries of advances written off	482	861	764	681	456
Total net advances written off	(1,017)	(1,250)	(3,440)	(5,751)	(5,776)

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	2017 **£m**	2016 £m	2015 £m	2014 £m	2013 £m
Effect of unwinding of discount recognised through interest income	(23)	(32)	(56)	(126)	(351)
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	(119)	(23)	33	(138)	224
Other personal lending	596	438	437	536	920
Agriculture, forestry and fishing	2	3	1	2	–
Energy and water supply	–	(4)	35	28	95
Manufacturing	5	(48)	23	(4)	31
Construction	85	143	13	(81)	66
Transport, distribution and hotels	(19)	(35)	(88)	198	421
Postal and telecommunications	1	191	(2)	6	(3)
Financial, business and other services	42	6	77	179	552
Property companies	(7)	(166)	(140)	40	457
Lease financing	–	15	31	(1)	(26)
Hire purchase	111	72	23	(30)	(12)
Loans and advances to banks	–	–	–	–	–
Total allowances for impairment losses charged against income for the year	697	592	443	735	2,725
Total balance at end of year	2,201	2,412	3,033	6,414	11,966
Ratio of net write-offs during the year to average loans outstanding during the year	0.2%	0.3%	0.8%	1.1%	1.1%

Following the reduction in the Group’s non-UK activities, an analysis between domestic and foreign operations is not provided.

The Group’s impairment allowances in respect of loans and advances to banks and customers decreased by £211 million, or 9 per cent, from £2,412 million at 31 December 2016 to £2,201 million at 31 December 2017. This decrease resulted from a charge to the income statement of £697 million being more than offset by net advances written off of £1,017 million (advances written off of £1,499 million less recoveries £482 million). The increase in the charge to the income statement of £105 million, or 18 per cent, from £592 million in 2016 to £697 million in 2017 reflects lower levels of releases and write-backs and the acquisition of MBNA. By category of lending, the most significant elements of the charge to the income statement were charges of £596 million in respect of other personal lending and £85 million in respect of construction together with a credit of £119 million in respect of mortgages. Of the net advances written off of £1,017 million, £506 million related to other personal lending, £152 million related to financial, business and other services and £136 million to property companies.

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

	2017 Allowance £m	**2017 Percentage of loans in each category to total loans %**	2016 Allowance £m	2016 Percentage of loans in each category to total loans %	2015 Allowance £m	2015 Percentage of loans in each category to total loans %	2014 Allowance £m	2014 Percentage of loans in each category to total loans %	2013 Allowance £m	2013 Percentage of loans in each category to total loans %
Balance at year end applicable to:										
Loans and advances to banks	–	1.4	–	5.5	–	5.2	–	5.1	–	4.8
Loans and advances to customers:										
Mortgages	485	63.4	576	63.0	479	64.7	460	64.7	657	63.5
Other personal lending	381	6.0	356	4.3	388	4.3	607	4.5	919	4.4
Agriculture, forestry and fishing	8	1.6	13	1.5	15	1.4	18	1.3	38	1.1
Energy and water supply	5	0.3	6	0.5	20	0.7	61	0.7	149	0.8
Manufacturing	35	1.6	84	1.5	70	1.2	179	1.2	296	1.4
Construction	410	0.9	319	0.9	165	1.0	158	1.3	395	1.3
Transport, distribution and hotels	57	2.9	161	2.7	219	2.8	1,051	2.9	1,954	4.2
Postal and telecommunications	5	0.4	5	0.5	4	0.5	17	0.5	11	0.4
Financial, business and other services	312	11.9	312	10.1	811	8.9	1,225	8.7	2,293	8.0
Property companies	343	6.4	470	6.6	790	6.7	2,553	7.1	5,145	8.3
Lease financing	–	0.4	–	0.5	–	0.6	1	0.6	6	0.8
Hire purchase	160	2.8	110	2.4	72	2.0	84	1.4	103	1.0
Total balance at year end	2,201	100.0	2,412	100.0	3,033	100.0	6,414	100.0	11,966	100.0

Following the reduction in the Group’s non-UK activities, an analysis between domestic and foreign operations is not provided.

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RISK ELEMENTS IN THE LOAN PORTFOLIO

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

NON-PERFORMING LENDING

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

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

The Group complies with IFRS 7, which requires detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, the table below shows separately those loans that are (i) neither past due nor impaired, (ii) past due but not impaired, (iii) impaired, not requiring a provision and (iv) impaired with a provision.

	Loans and advances to banks	**Loans and advances to customers**				**Loans and advances designated at fair value through profit or loss**
		Retail – mortgages	**Retail – other**	**Commercial**	**Total**	
(audited)	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
31 December 2017						
Neither past due nor impaired	6,577	295,765	48,897	116,396	461,058	31,590
Past due but not impaired	6	5,934	585	336	6,855	–
Impaired – no provision required	28	640	306	700	1,646	–
– provision held	–	3,529	1,053	1,613	6,195	–

Gross	6,611	305,868	50,841	119,045	475,754	31,590
31 December 2016						
Neither past due nor impaired	26,888	296,303	39,478	109,364	445,145	33,079
Past due but not impaired	14	7,340	386	305	8,031	–
Impaired – no provision required	–	784	392	689	1,865	–
– provision held	–	3,536	1,038	2,056	6,630	–
Gross	26,902	307,963	41,294	112,414	461,671	33,079
31 December 2015						
Neither past due nor impaired	25,006	302,063	38,886	100,001	440,950	33,174
Past due but not impaired	111	8,233	393	463	9,089	–
Impaired – no provision required	–	732	690	1,092	2,514	–
– provision held	–	3,269	911	2,896	7,076	–
Gross	25,117	314,297	40,880	104,452	459,629	33,174
31 December 2014						
Neither past due nor impaired	26,003	320,324	37,886	106,768	464,978	36,725
Past due but not impaired	152	10,311	674	488	11,473	–
Impaired – no provision required	–	578	938	847	2,363	–
– provision held	–	3,766	1,109	7,070	11,945	–
Gross	26,155	334,979	40,607	115,173	490,759	36,725
31 December 2013						
Neither past due nor impaired	25,219	318,668	36,789	107,764	463,221	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	131,203	509,175	29,443

The analysis of lending between retail and commercial 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 commercial are exposures to corporate customers and other large institutions.

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

	Loans and advances to banks	**Loans and advances to customers**				**Loans and advances designated at fair value through profit or loss**
		Retail – mortgages	**Retail – other**	**Commercial**	**Total**	
(audited)	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
31 December 2017						
0-30 days	6	3,057	458	246	3,761	–
30-60 days	–	1,115	111	10	1,236	–
60-90 days	–	785	3	13	801	–
90-180 days	–	977	3	8	988	–
Over 180 days	–	–	10	59	69	–
Total	6	5,934	585	336	6,855	–
31 December 2016						
0-30 days	14	3,547	285	157	3,989	–
30-60 days	–	1,573	75	37	1,685	–
60-90 days	–	985	2	74	1,061	–
90-180 days	–	1,235	6	14	1,255	–
Over 180 days	–	–	18	23	41	–
Total	14	7,340	386	305	8,031	–
31 December 2015						
0-30 days	111	4,066	276	248	4,590	–
30-60 days	–	1,732	81	100	1,913	–
60-90 days	–	1,065	9	52	1,126	–
90-180 days	–	1,370	8	19	1,397	–
Over 180 days	–	–	19	44	63	–
Total	111	8,233	393	463	9,089	–
31 December 2014						
0-30 days	152	4,854	453	198	5,505	–
30-60 days	–	2,309	110	51	2,470	–
60-90 days	–	1,427	90	139	1,656	–
90-180 days	–	1,721	5	38	1,764	–
Over 180 days	–	–	16	62	78	–
Total	152	10,311	674	488	11,473	–
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	146	12,329	580	786	13,695	–

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

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POTENTIAL PROBLEM LOANS

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

IFRS 7 requires the disclosure of information about the credit quality of loans and advances that are neither past due nor impaired. The Group's disclosures analyse these loans between those that the Group believes are of good quality, satisfactory quality, and lower quality and those that are below standard but not impaired. The below standard but not impaired balances represent potential problem loans.

	Loans and advances to banks	**Loans and advances to customers**				**Loans and advances designated at fair value through profit or loss**
		Retail – mortgages	**Retail – other**	**Commercial**	**Total**	
(audited)	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
31 December 2017						
Good quality	6,351	294,748	43,145	81,121		31,548
Satisfactory quality	198	790	4,770	30,154		42
Lower quality	28	32	286	4,807		–
Below standard, but not impaired	–	195	696	314		–
Total	6,577	295,765	48,897	116,396	461,058	31,590
31 December 2016						
Good quality	26,745	295,286	34,195	72,083		33,049
Satisfactory quality	87	814	4,479	30,433		30
Lower quality	3	39	387	6,433		–
Below standard, but not impaired	53	164	417	415		–
Total	26,888	296,303	39,478	109,364	445,145	33,079
31 December 2015						
Good quality	24,670	301,403	33,589	63,453		33,156
Satisfactory quality	311	527	4,448	28,899		15
Lower quality	4	27	476	7,210		3
Below standard, but not impaired	21	106	373	439		–
Total	25,006	302,063	38,886	100,001	440,950	33,174
31 December 2014						
Good quality	25,654	318,967	30,993	65,106		36,482
Satisfactory quality	263	1,159	5,675	28,800		238
Lower quality	49	72	623	11,204		5

Below standard, but not impaired	37	126	595	1,658		–
Total	26,003	320,324	37,886	106,768	464,978	36,725
31 December 2013						
Good quality	25,044	314,749	29,129	66,345		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	25,219	318,668	36,789	107,764	463,221	29,443

For further details see note 51 on page F-81.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

	2017
	£m
Interest income that would have been recognised under original contract terms	265
Interest income included in profit	(179)
Interest foregone	86

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TROUBLED DEBT RESTRUCTURINGS

In the US, loans whose terms have been modified due to problems with the borrower are required to be separately disclosed. If the new terms were in line with market conditions at the time of the restructuring and the restructured loan remains current as to repayment of principal and interest then the disclosure is discontinued at the end of the first year. The Company’s accounting policy for loans that are renegotiated is set out in note 2(H)(l) to the financial statements. The table below sets out loans that are forborne at 31 December 2017, 2016, 2015 and 2014, separately identifying those loans that are also impaired:

	Total forborne loans and advances which are not impaired £m	**Total forborne loans and advances which are impaired £m**	**Total loans and advances which are forborne £m**	**Impairment allowance as a % of loans and advances which are forborne %**
At 31 December 2017				
UK secured retail	1,291	137	1,428	4.3
UK unsecured retail	55	139	194	38.6
Consumer credit cards	105	190	295	36.0
Asset Finance UK Retail	15	19	34	36.6
Run off: Ireland secured retail	213	25	238	21.0
Commercial Banking	447	1,927	2,374	35.0
Run off: Corporate Real Estate, other Corporate and Specialist Finance	–	715	715	44.1
At 31 December 2016				
UK secured retail	1,879	217	2,096	4.7
UK unsecured retail	20	107	127	40.5
Consumer credit cards	93	119	212	29.0
Asset Finance UK Retail	55	62	117	27.0
Run off: Ireland secured retail	137	19	156	16.6
Commercial Banking[1]	466	2,197	2,663	31.1
Run off: Corporate Real Estate, other Corporate and Specialist Finance	3	995	998	51.1
At 31 December 2015				
UK secured retail	2,929	173	3,102	4.2
UK unsecured retail	28	119	147	40.0
Consumer credit cards	105	120	225	26.8
Asset Finance UK Retail	49	51	100	25.5

Run off: Ireland secured retail	143	26	169	13.3
Commercial Banking[1]	986	2,543	3,529	30.9
Run off: Corporate Real Estate, other Corporate and Specialist Finance	9	1,771	1,780	52.5
Run-off Ireland: Commercial real estate and corporate	32	5	37	0.0
At 31 December 2014				
UK secured retail	4,128	266	4,394	3.5
UK unsecured retail	23	139	162	39.4
Consumer credit cards	94	140	234	29.1
Asset Finance UK Retail	56	53	109	20.5
Run off: Ireland secured retail	239	41	280	12.7
Commercial Banking	1,896	3,241	5,137	31.0
Run off: Corporate Real Estate, other Corporate and Specialist Finance	86	1,912	1,998	58.3
Run-off Ireland: Commercial real estate and corporate	384	3,052	3,436	72.2

1 Restated.

The Group assesses whether a loan benefiting from a UK Government-sponsored programme is impaired or a troubled debt restructuring using the same accounting policies and practices as it does for loans not benefiting from such a programme.

Further information on the schemes operated by the Group to assist borrowers who are experiencing financial stress and on the Group’s forborne loans is set out on pages 57 to 61 and pages 66 to 71.

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ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES

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

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

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

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

CROSS BORDER OUTSTANDINGS

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

	Total	Governments and official institutions	Banks and other financial institutions	Commercial, industrial and other

	% of assets	£m	£m	£m	£m
At 31 December 2017:					
United States of America	1.6	12,963	6,760	3,205	2,998
At 31 December 2016:					
United States of America	1.6	13,224	7,564	1,718	3,942
At 31 December 2015:					
United States of America	1.5	11,748	6,349	952	4,447

At 31 December 2017, United States of America had commitments of £941 million.

At 31 December 2017, no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2016, no countries had cross border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2015, no countries had cross border outstandings of between 0.75 per cent and 1 per cent of assets.

REGULATORY AND LEGAL RISK

DEFINITION

Regulatory and legal risk is defined as the risk that the Group is exposed to fines, censure, or legal or enforcement action; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including codes of practice which could have legal implications), regulations, codes of conduct or legal obligations.

EXPOSURES

Whilst the Group has a zero risk appetite for material regulatory breaches or material legal incidents, the Group remains exposed to material regulatory breaches and material legal incidents outside of its risk appetite. Exposure is driven by significant ongoing and new legislation, regulation and court proceedings in the UK and overseas which in each case needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group.

MEASUREMENT

Regulatory and legal risks are measured against a set of risk appetite metrics, with appropriate thresholds, which are approved annually by the Board and which are regularly reviewed and monitored. Metrics include assessments of control and material regulatory rule breaches.

MITIGATION

The Group has have taken a number of steps and has outlined below the following key components:

- The Board establishes a Group-wide risk appetite and metrics for regulatory and legal risk;
- Group policies and procedures set out the principles and key controls that should apply across the business which are aligned to the Group risk appetite. Mandated policies and processes require appropriate control frameworks, management information, standards and colleague training to be implemented to identify and manage regulatory and legal risk;
- Business units assess and implement policy and regulatory requirements and establish local control, processes and procedures to ensure governance and compliance;
- Material risks and issues are escalated to divisional and then Group-level bodies which challenge and support the business on its management of them;

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- Business units regularly produce management information to assist in the identification of issues and test management controls are working effectively;
- Risk division and Legal provide oversight and proactive support and constructive challenge to the business in identifying and managing regulatory and legal issues;
- Risk division will conduct thematic reviews of regulatory compliance across businesses and divisions where appropriate; and
- Business units with the support of divisional and Group-level bodies conduct ongoing horizon scanning to identify and address changes in regulatory and legal requirements.

MONITORING

Business unit risk exposure is reported to Risk division where it is aggregated at Group level and a report prepared. The report forms the basis of challenge to the business at the monthly Group Conduct, Compliance and Operational Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory and legal sections in the Group's consolidated risk reporting.

CONDUCT RISK

DEFINITION

The risk of customer detriment due to poor design, distribution and execution of products and services or other activities which could undermine the integrity of the market or distort competition, leading to unfair customer outcomes, regulatory censure and financial and reputational loss.

EXPOSURES

The Group faces significant conduct risks, which affect all aspects of the Group's operations and all types of customers.

Conduct risks can impact directly or indirectly on the Group's customers and can materialise from a number of areas across the Group, including: sales processes resulting in poor customer outcomes; products and services not meeting the customers' needs; failing to deal with customers' complaints effectively; failing to promote effective competition in the interest of customers and failing to identify and report behaviour which could undermine the integrity of the market.

There is an ongoing high level of scrutiny regarding financial institutions' treatment of customers, including those in vulnerable circumstances, from regulatory bodies, the media, politicians and consumer groups. There is also a significant regulatory focus on market misconduct, resulting from previous issues which include London Interbank Offered Rate (LIBOR) and Foreign Exchange (FX).

As a result, there is a risk that certain aspects of the Group's current or legacy business may be determined by the Financial Conduct Authority, other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or in a manner that fails to deliver fair and reasonable customer treatment.

The Group may also be liable for damages to third parties harmed by the conduct of its business.

MEASUREMENT

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable conduct risk metrics and tolerances that indicate where it may potentially be operating outside its conduct appetite.

Conduct risk appetite metrics (CRAMs) have been designed for all product families offered by the Group; a set of common metrics supports a consistent approach across products and services. These contain a range of product design, sales and service metrics (such as sales volume, usage and customer outcome testing) to provide a more holistic view of conduct risks; each product also has additional bespoke metrics.

Each of the tolerances for the metrics are agreed for the individual product or service and are tracked monthly. At a consolidated level these metrics are part of the Board approved risk appetite. The Group is also evolving its approach to measurements supporting customer vulnerability and customer journeys.

Measurements in relation to market integrity continued to evolve in 2017, including additional business unit level risk control metrics to enhance the established suite of metrics (which already cover key topics such as the management of conflicts of interest and the handling of market sensitive information).

MITIGATION

The Group takes a range of mitigating actions with respect to conduct risk. The Group's ongoing commitment to good customer outcomes sets the tone from the top and supports the development of the right customer centric culture – strengthening links between actions to support conduct, culture and customer and enabling more effective control management. Actions to enable good conduct include:

– Conduct risk appetite established at Group and business area level, with metrics included in the Group risk appetite to ensure ongoing focus;

– Customer needs explicitly considered within business and product level planning and strategy, through divisional customer and culture plans, with integral conduct lens, reviewed and challenged by Group Customer First Committee (GCFC);

– Cultural transformation, supported by strong direction and tone from senior executives and the Board. This is underpinned by the Group's values and codes of responsibility, to deliver the best bank for customers;

– Further embedding of the customer vulnerability framework. The Customer Vulnerability Cross Divisional Committee operates at a senior level to prioritise change, drive implementation and ensure consistency across the Group. Significant partnership established with Macmillan to support customers with cancer;

– Embedding and evolving the Group's customer journey strategy and framework to support the Group's focus on conduct from an end-to-end customer perspective;

– Enhanced product governance framework to ensure products continue to offer customers fair value, and consistently meet their needs throughout their product life cycle;

– Enhanced complaints management through effectively responding to, and learning from, root causes to reduce complaint volumes and the Financial Ombudsman Service change rate;

– Enhanced recruitment and training, with a focus on how the Group manages colleagues' performance with clearer customer accountabilities; and

– Ongoing focus on the strategic conduct agenda in the Group's interactions with third parties involved in serving the Group's customers to ensure consistent delivery.

The Group continues to prioritise activity designed to reinforce good conduct in its engagement with the markets in which it operates, with the Market Conduct Steering Committee leading read-across activity of industry issues for LBG consideration. Further training has been delivered for colleagues, and the focus on enhanced procedures, and the enhancement of preventative and detective controls continues – including the Group's trade surveillance and continuous surveillance capability.

The Group's leadership team, through GCFC, support the development of the conduct agenda and priorities. The Board and Group Risk Committee receive regular qualitative and quantitative reports to track progress on how the Group is meeting customer needs and minimising conduct risk across all areas of the business.

The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of concerns related to customer treatment, effective competition and market integrity, to ensure that the Group's strategic conduct focus continues to meet evolving stakeholder expectations.

MONITORING

Monitoring and reporting is undertaken at Board, Group and business area committees. As part of the reporting of CRAMs, a robust outcomes testing regime for both sales and complaints processes is in place to test performance of customer critical activities.

GCFC has responsibility for monitoring and reviewing integrated measurement of enhanced outcomes and customer views, including challenging divisions to make changes based on key learnings to support the delivery of the Group's vision and foster a customer centric culture.

OPERATIONAL RISK

DEFINITION

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, which can lead to adverse customer impact, reputational damage or financial loss.

EXPOSURES

The principal operational risks to the Group are:

– A cyber-attack could result in customer detriment, financial loss, disruption and/or reputational damage;

– Failure in IT systems, due to volume of change, and/or aged infrastructure, could result in unfair customer outcomes, financial loss and/or reputational damage;

– Failure to protect and manage customers' data could result in customer detriment, financial loss, disruption and/or reputational damage;

– Internal and/or external fraud or financial crime could result in customer detriment, financial loss, disruption and/or reputational damage;

– Failure to ensure compliance with increasingly complex and detailed anti-money laundering, anti-terrorism, sanctions and prohibitions laws and regulations, as such a failure would adversely impact the Group's reputation and potentially incur fines and other legal enforcements; and

– Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events.

A number of these risks could increase where there is a reliance on third party suppliers to provide services to the Group or its customers.

MEASUREMENT

Operational risk is managed across the Group through an operational risk framework and operational risk policies. The operational risk framework includes a risk control self-assessment process, risk impact likelihood matrix, key risk and control indicators, risk appetite, a robust operational event management and escalation process, scenario analysis and operational losses process.

Table 1.28 below shows high level loss and event trends for the Group using Basel II categories. Based on data captured on the Group's Operational Risk System, in 2017 the highest frequency of events occurred in external fraud (64.37 per cent) and execution, delivery and process management (22.69 per cent). Clients, products and business practices accounted for 72.74 per cent of losses by value, driven by legacy issues where impacts materialised in 2017 (excluding PPI).

Table 1.28: Operational risk events by risk category (losses greater than or equal to £10,000), excluding PPI

	% of total volume		**% of total losses**	
	2017	2016	**2017**	2016
Business disruption and system failures	**1.35**	1.01	**0.92**	0.55
Clients, products and business practices	**10.12**	11.31	**72.74**	77.62
Damage to physical assets	**1.10**	1.05	**0.07**	0.27
Employee practices and workplace safety	**–**	0.04	**–**	–
Execution, delivery and process management	**22.69**	24.80	**22.80**	19.23
External fraud	**64.37**	61.58	**3.50**	2.31
Internal fraud	**0.37**	0.21	**(0.03)**	0.02
Total	**100.00**	100.00	**100.00**	100.00

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Operational risk losses and scenario analysis is used to inform the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its minimum (Pillar I) operational risk capital requirements using The Standardised Approach (TSA). Pillar II is calculated using Internal and External loss data and extreme but plausible scenarios that may occur in the next 12 months.

MITIGATION

The Group's strategic review considers the changing risk management requirements, adapting the change delivery model to be more agile and develop the people skills and capabilities needed to be the 'Bank of the Future'. The Group continues to review and invest in its control environment to ensure it addresses the inherent risks faced. Risks are reported and discussed at local governance forums and escalated to executive management and Board as appropriate to ensure the correct level of visibility and engagement. The Group employs a range of risk management strategies, including: avoidance, mitigation, transfer (including insurance) and acceptance. Where there is a reliance on third party suppliers to provide services, the Group's sourcing policy ensures that outsourcing initiatives follow a defined process including due diligence, risk evaluation and ongoing assurance.

Mitigating actions to the principal operational risks are:

- The threat landscape associated with cyber risk continues to evolve and there is significant regulatory attention on this subject. The Board has defined a cyber risk appetite and has completed a three year programme to deliver capability to meet that risk appetite. Given the nature of the threat, the Group continues to invest heavily in protecting against malicious cyber-attacks and is commencing further investment in enhancing the protection of its customers and their data, improving capability to detect and respond to attacks and protecting its most critical systems.

- The Group continues to optimise its approach to IT and operational resilience by investing in technology improvements and enhancing the resilience of systems that support the Group's critical business processes, primarily through the Technology Resilience Programme, with independent verification of progress on an annual basis. The Board recognises the role that resilient technology plays in achieving the Group's strategy of becoming the best bank for customers and in maintaining banking services across the wider industry. As such, the Board dedicates considerable time and focus to this subject at both the Board and the Board Risk Committee, and continues to sponsor key investment programmes that enhance resilience.

- The Group is making a significant investment to improve data privacy, including the security of data and oversight of third parties. The Group's strategy is to introduce advanced data management practices, based on Group-wide standards, data-first culture and modern enterprise data platforms, supported by a simplified modern IT architecture.

- The Group adopts a risk based approach to mitigate the internal and external fraud risks it faces, reflecting the current and emerging fraud risks within the market. Fraud risk appetite metrics have been defined, holistically covering the impacts of fraud in terms of losses to the Group, costs of fraud systems and operations, and customer experience of actual and attempted fraud. Oversight of the appropriateness and performance of these metrics is undertaken regularly through business area and Group-level committees. This approach drives a continual programme of prioritised enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Group-wide policies and operational control frameworks are maintained and designed to provide customer confidence, protect the Group's commercial interests and reputation, comply with legal requirements and meet regulatory expectations. The Group's fraud awareness programme remains a key component of its fraud control environment, and awareness of fraud risk is supported by mandatory training for all colleagues. The Group also plays an active role with other financial institutions, industry bodies, and enforcement agencies in identifying and combatting fraud.

The Group has adopted policies and procedures designed to detect and prevent the use of its banking network for money laundering, terrorist financing, bribery, tax evasion, human trafficking, and modern-day slavery, and activities prohibited by legal and regulatory sanctions. Against a background of increasingly complex and detailed laws and regulations, and of increased criminal and terrorist activity, the Group regularly reviews and assesses its policies, procedures and organisational arrangements to keep them current, effective and consistent across markets and jurisdictions. The Group requires mandatory training on these topics for all employees. Specifically, the anti-money laundering procedures include 'know-your-customer' requirements, transaction monitoring technologies, reporting of suspicions of money laundering or terrorist financing to the applicable regulatory authorities, and interaction between the Group's Financial Intelligence Unit and external agencies and other financial institutions. The Anti-Bribery Policy prohibits the payment, offer, acceptance or request of a bribe, including 'facilitation payments' by any employee or agent and provides a confidential reporting service for anonymous reporting for suspected or actual bribery activity. The Sanctions and Related Prohibitions Policy sets out a framework of controls for compliance with legal and regulatory sanctions.

Operational resilience measures and recovery planning defined in the Group's Resilience and Continuity (including Incident Management) Policy ensure an appropriate and consistent approach to the management of continuity risks, including potential interruptions from a range of internal and external incidents or threats including environmental and climatic issues, terrorism, cyber, economic instability, pandemic planning and operational incidents. The Group considers its operational resilience across five key pillars; cyber, third parties, IT, people and property.

MONITORING

Monitoring and reporting of operational risk is undertaken at Board, Group and divisional risk committees. Each committee monitors key risks, control effectiveness, key risk and control indicators, events, operational losses, risk appetite metrics and the results of independent testing conducted by Risk and/or Group Internal Audit.

The Group maintains a formal approach to operational risk event escalation, whereby material events are identified, captured and escalated. Root causes of events are determined, where possible, and action plans put in place to ensure an optimum level of control to keep customers and the business safe, reduce costs, and improve efficiency.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

PEOPLE RISK

DEFINITION

The risk that the Group fails to provide an appropriate colleague and customer centric culture, supported by robust reward and wellbeing policies and processes; effective leadership to manage colleague resources; effective talent and succession management; and robust control to ensure all colleague-related requirements are met.

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EXPOSURES

The Group's management of material people risks is critical to its capacity to deliver against its strategic objectives and to be the best bank for customers. Over the coming year the Group anticipates the following key people risk exposures:

- Maintaining organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change;
- Senior Managers and Certification Regime (SM&CR) and additional regulatory constraints on remuneration structures may impact the Group's ability to attract and retain talent;
- The increasing digitisation of the business is changing the capability mix required and may impact the Group's ability to attract and retain talent; and
- Colleague engagement may continue to be challenged by ongoing media attention on banking sector culture, sales practices and ethical conduct.

MEASUREMENT

People risk is measured through a series of quantitative and qualitative indicators, aligned to key sources of people risk for the Group such as succession, retention, colleague engagement and performance management. In addition to risk appetite measures and limits, people risks and controls are monitored on a monthly basis via the Group's risk governance framework and reporting structures.

MITIGATION

The Group takes many mitigating actions with respect to people risk. Key areas of focus include:

- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Continued focus on the Group's culture by developing and delivering initiatives that reinforce the appropriate behaviours which generate the best possible long-term outcomes for customers and colleagues;

- Managing organisational capability and capacity through divisional people strategies to ensure there are the right skills and resources to meet the Group's customers' needs and deliver the Group's strategic plan;

- Maintain effective remuneration arrangements to ensure they promote an appropriate culture and colleague behaviours that meet customer needs and regulatory expectations;

- Ensuring compliance with legal and regulatory requirements related to SM&CR, embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities; and

- Ongoing consultation with the Group's recognised unions on changes which impact their members.

MONITORING

People risks from across the Group are monitored and reported through Board and Group Governance Committees in accordance with the Group's Risk Management Framework and people risk sub-framework. Risk exposures are discussed monthly via the Group People Risk Committee with upwards reporting to Group Risk and Executive Committees. In addition, oversight, challenge and reporting is completed at Risk division level and, combined with risk assurance, Risk division reviews and assesses the effectiveness of controls, recommending follow up remedial action if relevant. All material people risk events are escalated in accordance with the formal Group Operational Risk Policy and People Policies to the respective divisional Managing Directors and the Group Director, Conduct, Compliance and Operational Risk.

INSURANCE UNDERWRITING RISK

DEFINITION

Insurance underwriting risk is defined as the risk of adverse developments in longevity, mortality, persistency, General Insurance underwriting and policyholder behaviour, leading to reductions in earnings and/or value.

EXPOSURES

The major source of insurance underwriting risk within the Group is the Insurance business.

Longevity and persistency are key risks within the life and pensions business. Longevity risk arises from the annuity portfolios where policyholders' future cashflows are guaranteed at retirement and increases in life expectancy, beyond current assumptions, will increase the cost of annuities. Longevity risk exposures are expected to increase with the Insurance business growth in the bulk annuity market. Persistency assumptions are set to give a best estimate, however customer behaviour may result in increased cancellations or cessation of contributions.

Property insurance risk is a key risk within the General Insurance business, through Home Insurance. Exposures can arise, for example, in extreme weather conditions, such as flooding, when property damage claims are higher than expected.

The Group's defined benefit pension schemes also expose the Group to longevity risk. For further information please refer to the defined benefit pension schemes component of the market risk section and note 35 to the financial statements.

MEASUREMENT

Insurance underwriting risks are measured using a variety of techniques including stress, reverse stress and scenario testing, as well as stochastic modelling. Current and potential future insurance underwriting risk exposures are assessed and aggregated on a range of stresses including risk measures based on 1-in-200 year stresses for Insurance's regulatory capital assessments and other supporting measures where appropriate, including those set out in note 32 to the financial statements.

MITIGATION

Insurance underwriting risk in the Insurance business is mitigated in a number of ways:

- General Insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements;
- Insurance processes on underwriting, claims management, pricing and product design;
- Longevity risk transfer and hedging solutions are considered on a regular basis and in 2017 the Group reinsured £1.3 billion of annuitant longevity. A team of longevity and bulk pricing experts has been built to support the new bulk annuity proposition; and
- Exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite.

MONITORING

Insurance underwriting risks in the Insurance business are monitored by Insurance senior executive committees and ultimately the Insurance Board. Significant risks from the Insurance business and the defined benefit pension schemes are reviewed by the Group Executive and Group Risk Committees and/or Board.

Insurance underwriting risk exposures within the Insurance business are monitored against risk appetite. The Insurance business monitors experiences against expectations, for example business volumes and mix, claims and persistency experience. The effectiveness of controls put in place to manage insurance underwriting risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken.

CAPITAL RISK

DEFINITION

Capital risk is defined as the risk that the Group has a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the Group.

EXPOSURES

A capital risk exposure arises when the Group has insufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. This could arise due to a depletion of the Group's capital resources as a result of the crystallisation of any of the risks to which it is exposed. Alternatively a shortage of capital could arise from an increase in the amount of capital that needs to be held. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures while optimising value for shareholders.

MEASUREMENT

The Group measures the amount of capital it requires and holds through applying the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA) and supplemented through additional regulation under the PRA Rulebook. Full details of the Group's regulatory capital and leverage frameworks, including the means by which its capital and leverage requirements and capital resources are calculated, will be provided in the Group's Pillar 3 Report.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of aggregate risk-weighted assets. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital and at least 6 per cent of risk-weighted assets are required to be covered by tier 1 capital. These minimum Pillar 1 requirements are supplemented by additional minimum requirements under Pillar 2A of the regulatory framework, the aggregate of which is to be referred to as the Group's Total Capital Requirement (TCR) from 1 January 2018, and a number of regulatory capital buffers as described below.

Additional minimum requirements under Pillar 2A are currently set by the PRA through the issuance of bank specific Individual Capital Guidance (ICG). This reflects a point in time estimate by the PRA, which may change over time, of the minimum amount of capital that is needed by the bank to cover risks that are not fully covered by Pillar 1, such as credit concentration and operational risk, and those risks not covered at all by Pillar 1, such as pensions and interest rate risk in the banking book (IRRBB). From 1 January 2018, Pillar 2A will be set as a firm specific capital requirement (Pillar 2R) rather than as individual capital guidance.

The Group is also required to maintain a number of regulatory capital buffers, which are required to be met with CET1 capital.

Systemic buffers are designed to hold systemically important banks to higher capital standards, so that they can withstand a greater level of stress before requiring resolution.

– Although the Group is not currently classified as a global systemically important institution (G-SII) under the Capital Requirements Directive, it has been classified as an 'other' systemically important institution (O-SII) by the PRA. The O-SII buffer is set to zero in the UK.

– The Systemic Risk Buffer (SRB) will be applied to UK ring-fenced banks from early 2019. The size of buffer applied to the Group's ring-fenced bank (RFB) sub-group in 2019 will be dependent upon the total assets of the sub-group. The FPC anticipates applying a buffer of 2.5 per cent to the largest ring-fenced institutions. Although the SRB will apply at a sub consolidated level within the Group's structure, the PRA have indicated that they will include in the Group's PRA Buffer an amount equivalent to the RFB's Systemic Risk Buffer. The amount included in the PRA Buffer is expected to be lower as a percentage of Group risk-weighted assets reflecting the assets of the Group that will not be held in the RFB sub-group and for which the SRB will not apply to.

The capital conservation buffer (CCB) is a standard buffer of 2.5 per cent of risk-weighted assets designed to provide for losses in the event of stress and is being phased in over the period from 1 January 2016 to 1 January 2019. During 2017 it was 1.25 per cent and during 2018 it will increase to 1.875 per cent.

The countercyclical capital buffer (CCyB) is time-varying and is designed to require banks to hold additional capital to remove or reduce the build-up of systemic risk in times of credit boom, providing additional loss absorbing capacity and acting as an incentive for banks to constrain further credit growth.

The amount of the buffer is determined by reference to buffer rates set by the (FPC) for the individual countries where the Group has relevant credit risk exposures. The CCyB rate for the UK is currently set at zero but will increase to 0.5 per cent on 27 June 2018 and to 1.0 per cent on 28 November 2018. The FPC will reconsider the adequacy of a 1.0 per cent UK CCyB rate during the first half of 2018 in light of the evolution of the overall risk environment. Non-zero buffer rates currently apply for Norway, Sweden, Hong Kong, Iceland, Slovakia and the Czech Republic. Given that the Group has minimal exposures to these jurisdictions, the overall countercyclical capital buffer requirement at 31 December 2017 is considered to be negligible.

As part of the capital planning process, forecast capital positions are subjected to extensive stress analyses to determine the adequacy of the Group's capital resources against the minimum requirements, including the ICG. The PRA uses the outputs from some of these stress analyses as one of the inputs that inform the setting of a bank-specific capital buffer for the Group, known as the PRA Buffer. The PRA Buffer also takes into account the CCB and CCyB. The PRA requires the PRA Buffer to remain confidential between the Group and the PRA.

All buffers are required to be met with CET1 capital. A breach of the PRA buffer would trigger a dialogue between the Group and the PRA to agree what action is required whereas a breach of the CRD IV combined buffer (all regulatory buffers excluding the PRA buffer) would give rise to automatic constraints upon any discretionary capital distributions by the Group.

In addition to the risk-based capital framework outlined above, the Group is also subject to minimum capital requirements under the UK Leverage Ratio Framework. The leverage ratio is calculated by dividing fully loaded tier 1 capital resources by a defined measure of on-balance sheet assets and off-balance sheet items.

The minimum leverage ratio requirement under the UK Leverage Ratio Framework is 3.25 per cent. In addition the framework requires two buffers to be maintained: an Additional Leverage Ratio Buffer (ALRB), which is calculated as 35 per cent of the Systemic Risk Buffer (applicable from 2019) and a time-varying Countercyclical Leverage Buffer (CCLB) which is calculated as 35 per cent of the countercyclical capital buffer rate (currently set at 0 per cent). At least 75 per cent of the minimum 3.25 per cent requirement and the entirety of any buffers that may apply must be met by CET1 capital.

The leverage ratio framework does not currently give rise to higher capital requirements for the Group than the risk-based capital framework.

MITIGATION

The Group has a capital management framework including policies and procedures that are designed to ensure that it operates within its risk appetite, uses its capital resources efficiently and continues to comply with regulatory requirements.

The Group is able to accumulate additional capital through the retention of profits over time, which can be enhanced through cutting costs and reducing or cancelling dividend payments, by raising new equity via, for example, a rights issue or debt exchange and by raising additional tier 1 or tier 2 capital through issuing tier 1 instruments or subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demand for capital through management actions including adjusting its lending strategy, risk hedging strategies and through business disposals.

Additional measures to manage the Group’s capital position include seeking to optimise the generation of capital demand within the Group’s businesses to strike an appropriate balance of capital held within the Group’s Insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises.

MONITORING

Capital is actively managed and monitoring capital ratios is a key factor in the Group’s planning processes and stress analyses. Multi-year forecasts of the Group’s capital position, based upon the Group’s operating plan, are produced at least annually to inform the Group’s capital plan whilst shorter term forecasts are more frequently undertaken to understand and respond to variations of the Group’s actual performance against the plan. The capital plans are tested for capital adequacy using a range of stress scenarios covering adverse economic conditions as well as other adverse factors that could impact the Group and the Group maintains a recovery plan which sets out a range of potential mitigating actions that could be taken in response to a stress.

Regular reporting of actual and projected ratios, including those in stressed scenarios, is undertaken, including submissions to the Group Capital Risk Committee (GCRC), Group Financial Risk Committee (GFRC), Group Asset and Liability Committee (GALCO), Group Risk Committee (GRC), Board Risk Committee (BRC) and the Board. Capital policies and procedures are subject to independent oversight.

The regulatory framework within which the Group operates continues to evolve and further detail on this will be provided in the Group’s Pillar 3 report. The Group continues to monitor these developments very closely, analysing the potential capital impacts to ensure that, through organic capital generation, the Group continues to maintain a strong capital position that exceeds both minimum regulatory requirements and the Group’s risk appetite and is consistent with market expectations.

Target capital ratios

The Board's view of the level of CET1 capital required is c.13 per cent plus a management buffer of around 1 per cent.

This takes into account, amongst other things:

– the Pillar 2A ICG set by the PRA, reflecting their point in time estimate, which may change over time, of the amount of capital that is needed in relation to risks not covered by Pillar 1. During the year the PRA updated the Group's ICG representing an increase from 4.5 per cent to 5.4 per cent of risk-weighted assets at 31 December 2017, of which 3.0 per cent has to be met by CET1 capital.

– the PRA Buffer, which they set taking into account the results of the PRA stress tests and other information, as well as outputs from the Group's internal stress tests. The PRA requires the PRA Buffer itself to remain confidential between the Group and the PRA.

– future regulatory developments, including the introduction of the Systemic Risk Buffer in early 2019 and the CCyB on UK exposures during the course of 2018.

Dividend policy

The Group intends to maintain an ordinary dividend policy that is both progressive and sustainable. The rate of growth of the ordinary dividend will be decided by the Board in light of the circumstances at the time.

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The Board also gives due consideration to the distribution of surplus capital through the use of special dividends or share buybacks. Surplus capital represents the return of capital over and above the Board's view of the current level of capital required to grow the business, meet regulatory requirements and cover uncertainties. The amount of required capital may vary from time to time depending on circumstances and by its nature there can be no guarantee that any surplus capital distribution will be appropriate in future years.

The ability of the Group to pay a dividend is also subject to constraints including the availability of distributable reserves, legal and regulatory restrictions and the financial and operating performance of the entity.

Distributable reserves are determined as required by the Companies Act 2006 by reference to a company's individual financial statements. At 31 December 2017 Lloyds Banking Group plc ('the Company') had accumulated distributable reserves of approximately £8.5 billion. Substantially all of the Company's merger reserve is available for distribution under UK company law as a result of transactions undertaken to recapitalise the Company in 2009.

Lloyds Banking Group plc acts as a holding company which also issues capital and other securities to capitalise and fund the activities of the Group. The profitability of the holding company, and consequently its ability to sustain dividend payments, is therefore dependent upon the continued receipt of dividends from its subsidiaries (representing both banking and insurance). A number of Group subsidiaries, principally those with banking and insurance activities, are also subject to regulatory capital requirements. These require entities to maintain minimum amounts of capital related to their size and risk. The principal operating subsidiary is Lloyds Bank plc which, at 31 December 2017, had a consolidated CET1 capital ratio of 15.8 per cent (31 December 2016: 15.1 per cent). The Group actively manages the capital of its subsidiaries, which includes monitoring the regulatory capital ratios for its banking and insurance subsidiaries against approved risk appetite limits. It operates a formal capital management policy which requires all subsidiary entities to remit any surplus capital to their parent companies.

Analysis of capital position

Excluding the capital impact of the acquisition of MBNA on 1 June 2017, the Group generated 2.63 per cent of CET1 capital on an adjusted basis before ordinary dividends and allowing for the share buyback, primarily as a result of:

- Strong underlying capital generation of 2.5 per cent, largely driven by underlying profits (2.2 per cent) and the dividend paid by the Insurance business in February 2018 in relation to 2017 earnings (0.3 per cent);

- A reduction in risk-weighted assets (prior to the impact of the acquisition of MBNA) resulting in an increase of 0.8 per cent, primarily reflecting updates made to both mortgage and unsecured retail IRB models, continued active portfolio management, foreign exchange movements, disposals and capital efficient securitisation activity, partly offset through targeted growth in key customer segments;

- The impact of market and other movements, generating an increase of 0.4 per cent, partially reflecting positive movements in available-for-sale assets and the defined benefit pension schemes;
- Offset by a reduction of (1.1) per cent for conduct provisions.

In addition, the Group utilised the 0.8 per cent of CET1 capital retained at 31 December 2016 to cover the acquisition of MBNA.

Overall the Group's CET1 ratio has strengthened to 15.5 per cent on an adjusted basis before ordinary dividends and the share buyback. After ordinary dividends the Group's CET1 ratio was 14.4 per cent on an adjusted basis. In addition the Board intends to implement a share buyback programme of up to £1 billion, equivalent to up to 1.4 pence per share. The buyback will impact the Group's capital position in 2018 and is expected to reduce CET1 capital by c.50 basis points. Allowing for this at 31 December 2017 the adjusted CET1 ratio would be 13.9 per cent (31 December 2016: 12.9 per cent on an adjusted basis after dividends and adjusting for MBNA).

Prior year comparatives reflect the additional provision of £350 million recorded following the clarification provided by the FCA on 2 March 2017 in relation to the consultation paper dealing with PPI. This resulted in a reduction of the adjusted CET1 ratio at 31 December 2016 by 18 basis points.

The accrual for foreseeable dividends reflects the recommended final ordinary dividend of 2.05 pence per share.

The transitional total capital ratio, after ordinary dividends remained unchanged at 21.2 per cent, largely reflecting amortisation on dated tier 2 instruments and foreign exchange movements on tier 1 and tier 2 instruments, offset by the increase in CET1 capital and the reduction in risk-weighted assets.

Applying the Bank of England's Minimum Requirement for Own Funds and Eligible Liabilities (MREL) policy to current capital requirements, the Group's indicative MREL requirement, excluding regulatory capital buffers, is as follows:

- From 2020, 2 times Pillar 1 plus Pillar 2A, equivalent to 21.4 per cent of risk-weighted assets
- From 2022, 2 times Pillar 1 plus 2 times Pillar 2A, equivalent to 26.8 per cent of risk-weighted assets

The Bank of England will review the calibration of MREL in 2020 before setting final end-state requirements to be met from 2022. This review will take into consideration any changes to the capital framework, including the finalisation of Basel III.

During 2017, the Group issued £8.5 billion (sterling equivalent as at 31 December 2017) of senior unsecured securities from Lloyds Banking Group plc which, while not included in total capital, are eligible to meet MREL. Combined with previous issuances made during 2016 the Group remains comfortably positioned to meet MREL requirements from 2020 and, as at 31 December 2017, had a transitional MREL ratio of 25.7 per cent of risk-weighted assets.

The UK leverage ratio, after ordinary dividends, increased from 5.2 per cent on an adjusted basis to 5.4 per cent on an adjusted basis, largely reflecting the increase in fully loaded tier 1 capital and the underlying reduction in balance sheet assets, net of qualifying central bank claims and deconsolidation adjustments.

An analysis of the Group's capital position as at 31 December 2017 is presented in the following section on both a CRD IV transitional arrangements basis and a CRD IV fully loaded basis.

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The table below summarises the consolidated capital position of the Group. The Group's Pillar 3 Report will provide a comprehensive analysis of the own funds of the Group.

Table 1.29: Capital resources (audited)

	Transitional		Fully loaded	
	At 31 Dec 2017 £m	At 31 Dec 2016 £m	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Common equity tier 1				
Shareholders' equity per balance sheet	43,551	42,670	43,551	42,670
Adjustment to retained earnings for foreseeable dividends	(1,475)	(1,568)	(1,475)	(1,568)
Deconsolidation adjustments[1]	1,301	1,342	1,301	1,342
Adjustment for own credit	109	87	109	87
Cash flow hedging reserve	(1,405)	(2,136)	(1,405)	(2,136)
Other adjustments	(177)	(276)	(177)	(276)
	41,904	40,119	41,904	40,119
less: deductions from common equity tier 1				
Goodwill and other intangible assets	(2,966)	(1,623)	(2,966)	(1,623)
Prudent valuation adjustment	(556)	(630)	(556)	(630)
Excess of expected losses over impairment provisions and value adjustments	(498)	(602)	(498)	(602)
Removal of defined benefit pension surplus	(541)	(267)	(541)	(267)
Securitisation deductions	(191)	(217)	(191)	(217)
Significant investments[1]	(4,250)	(4,317)	(4,250)	(4,317)
Deferred tax assets	(3,255)	(3,564)	(3,255)	(3,564)
Common equity tier 1 capital	29,647	28,899	29,647	28,899
Additional tier 1				
Other equity instruments	5,330	5,320	5,330	5,320
Preference shares and preferred securities[2]	4,503	4,998	–	–
Transitional limit and other adjustments	(1,748)	(1,692)	–	–
	8,085	8,626	5,330	5,320
less: deductions from tier 1				
Significant investments[1]	(1,403)	(1,329)	–	–
Total tier 1 capital	36,329	36,196	34,977	34,219
Tier 2				
Other subordinated liabilities[2]	13,419	14,833	13,419	14,833
Deconsolidation of instruments issued by insurance entities[1]	(1,786)	(1,810)	(1,786)	(1,810)
Adjustments for transitional limit and non-eligible instruments	1,617	1,351	(1,252)	(1,694)
Amortisation and other adjustments	(3,524)	(3,447)	(3,565)	(3,597)
	9,726	10,927	6,816	7,732
Eligible provisions	120	186	120	186
less: deductions from tier 2				

Significant investments[1]	(1,516)	(1,571)	(2,919)	(2,900)
Total capital resources	44,659	45,738	38,994	39,237
Risk-weighted assets	210,919	215,446	210,919	215,446
Common equity tier 1 capital ratio[3]	14.1 %	13.4 %	14.1 %	13.4 %
Tier 1 capital ratio	17.2 %	16.8 %	16.6 %	15.9 %
Total capital ratio	21.2 %	21.2 %	18.5 %	18.2 %

1 For regulatory capital purposes, the Group's Insurance business is deconsolidated and replaced by the amount of the Group's investment in the business. A part of this amount is deducted from capital (shown as 'significant investments' in the table above) and the remaining amount is risk-weighted, forming part of threshold risk-weighted assets.

2 Preference shares, preferred securities and other subordinated liabilities are categorised as subordinated liabilities in the balance sheet.

3 The common equity tier 1 ratio is 14.4 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2018 in relation to its 2017 earnings (31 December 2016: 13.7 per cent on an adjusted basis).

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The key difference between the transitional capital calculation as at 31 December 2017 and the fully loaded equivalent is primarily related to capital securities that previously qualified as tier 1 or tier 2 capital, but that do not fully qualify under CRD IV, which can be included in additional tier 1 (AT1) or tier 2 capital (as applicable) up to specified limits which reduce by 10 per cent per annum until 2022.

The movements in the transitional CET1, AT1, tier 2 and total capital positions in the period are provided below.

Table 1.30: Movements in capital resources

	Common Equity tier 1 £m	Additional Tier 1 £m	Tier 2 £m	Total capital £m
At 31 December 2016	28,899	7,297	9,542	45,738
Profit attributable to ordinary shareholders[1]	2,864	–	–	2,864
Movement in foreseeable dividends[2]	93	–	–	93
Dividends paid out on ordinary shares during the year	(2,284)	–	–	(2,284)
Dividends in respect of 2016 earnings and 2017 interim earnings received from the Insurance business[1]	575	–	–	575
Movement in treasury shares and employee share schemes	3	–	–	3
Pension movements:				
Removal of defined benefit pension surplus	(274)	–	–	(274)
Movement through other comprehensive income	428	–	–	428
Available-for-sale reserve	(74)	–	–	(74)
Prudent valuation adjustment	74	–	–	74
Deferred tax asset	309	–	–	309
Goodwill and other intangible assets	(1,343)	–	–	(1,343)
Excess of expected losses over impairment provisions and value adjustments	104	–	–	104
Significant investments	67	(74)	55	48
Eligible provisions	–	–	(66)	(66)
Movements in subordinated debt:				
Repurchases, redemptions and other	–	(541)	(1,201)	(1,742)
Other movements	206	–	–	206
At 31 December 2017	29,647	6,682	8,330	44,659

1 Under the regulatory framework, profits made by Insurance are removed from CET1 capital. However, when dividends are paid to the Group by Insurance these are recognised through CET1 capital.

2 Includes the accrual for the 2017 full year ordinary dividend and the reversal of the accrual for the 2016 full year ordinary and special dividends which were paid during the year.

CET1 capital resources have increased by £748 million in the year, primarily reflecting a combination of profit generation, dividends received from the Insurance business during the year, movements in the defined benefit pension schemes and a reduction in the deferred tax asset deducted from capital, partially offset by the payment of the 2017 interim dividend, the accrual of the full year ordinary dividend and an increase in the deduction for goodwill and other intangible assets, largely in relation to the acquisition of MBNA.

AT1 capital resources have reduced by £615 million in the year, primarily reflecting the annual reduction in the transitional limit applied to grandfathered AT1 capital instruments and foreign exchange movements.

Tier 2 capital resources have reduced by £1,212 million in the year largely reflecting the amortisation of dated tier 2 instruments and foreign exchange movements on subordinated debt, partly offset by the transitioning of grandfathered AT1 instruments to tier 2.

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Table 1.31: Risk-weighted assets

	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Foundation Internal Ratings Based (IRB) Approach	60,207	64,907
Retail IRB Approach	61,588	64,970
Other IRB Approach	17,191	17,788
IRB Approach	138,986	147,665
Standardised (STA) Approach	25,503	18,956
Credit risk	164,489	166,621
Counterparty credit risk	6,055	8,419
Contributions to the default fund of a central counterparty	428	340
Credit valuation adjustment risk	1,402	864
Operational risk	25,326	25,292
Market risk	3,051	3,147
Underlying risk-weighted assets	200,751	204,683
Threshold risk-weighted assets[1]	10,168	10,763
Total risk-weighted assets	210,919	215,446

1 Threshold risk-weighted assets reflect the element of significant investments and deferred tax assets that are permitted to be risk-weighted instead of being deducted from CET1 capital. Significant investments primarily arise from investment in the Group's Insurance business.

Table 1.32: Risk-weighted assets movement by key driver

	Credit risk IRB £m	**Credit risk STA £m**	**Credit risk[1] £m**	**Counterparty credit risk[2] £m**	**Market risk £m**	**Operational risk £m**	**Total £m**
Total risk-weighted assets as at 31 December 2016							215,446
Less total threshold risk-weighted assets[3]							(10,763)
Risk-weighted assets as at 31 December 2016	147,665	18,956	166,621	9,623	3,147	25,292	204,683
Asset size	(2,465)	100	(2,365)	(403)	–	–	(2,768)
Asset quality	322	(112)	210	(222)	–	–	(12)
Model updates	(4,399)	–	(4,399)	–	349	–	(4,050)
Methodology and policy	(789)	434	(355)	(431)	–	–	(786)

Acquisitions and disposals	(606)	6,237	5,631	(26)	–	930	6,535
Movements in risk levels (market risk only)	–	–	–	–	(445)	–	(445)
Foreign exchange	(742)	(112)	(854)	(656)	–	–	(1,510)
Other	–	–	–	–	–	(896)	(896)
Risk-weighted assets as at 31 December 2017	138,986	25,503	164,489	7,885	3,051	25,326	200,751
Threshold risk-weighted assets[3]							10,168
Total risk-weighted assets as at 31 December 2017							210,919

1 Credit risk includes securitisation risk-weighted assets.

2 Counterparty credit risk includes movements in contributions to the default fund of central counterparties and movements in credit valuation adjustment risk.

3 Threshold risk-weighted assets reflect the element of significant investments and deferred tax assets that are permitted to be risk-weighted instead of being deducted from CET1 capital. Significant investments primarily arise from investment in the Group's Insurance business.

The risk-weighted assets movement tables provide analyses of the movement in risk-weighted assets in the period by risk type and an insight into the key drivers of the movements. The key driver analysis is compiled on a monthly basis through the identification and categorisation of risk-weighted asset movements and is subject to management judgment.

Credit risk-weighted assets reductions of £2.1 billion were driven by the following key movements:

– Asset size saw a reduction of £2.4 billion due to continued active portfolio management, partly offset by targeted growth in key customer segments.

– Model update reductions of £4.4 billion were mainly due to PRA approved model changes within the mortgage and unsecured retail portfolios.

– Methodology and policy reductions of £0.4 billion were principally the result of further capital efficient securitisation activity.

– Acquisitions and disposals increased by £5.6 billion and were primarily driven by the acquisition of MBNA, partly offset by the disposal of the Group's interest in a strategic equity investment.

– Sterling foreign exchange movements, principally with the Euro and US Dollar, contributed to an overall reduction in credit risk-weighted assets of £0.9 billion.

Counterparty credit risk and CVA risk-weighted assets reductions of £1.7 billion were mainly driven by foreign exchange movements, reductions in position levels, updates to the calculation methodology following clarification of the regulatory approach and other movements.

Market risk, risk-weighted assets reduced by £0.1 billion largely due to a decrease in interest rate risk exposure, offset by an increase in the VaR multiplier, an increase in exposure to corporate bonds and refinements to internal models.

Operational risk, risk-weighted assets are broadly in line with the prior year, with the increase following the acquisition of MBNA mostly offset by the annual update of the income based Standardised Approach operational risk calculation.

Stress testing

The Group undertakes a wide ranging programme of stress testing providing a comprehensive view of the potential impacts arising from the risks to which the Group is exposed. One of the most important uses of stress testing is to assess the resilience of the operational and strategic plans of the Group to adverse economic conditions and other key vulnerabilities. As part of this programme, and in line with previous years, the Group conducted macroeconomic stress tests of the operating plan.

The concurrent UK stress test run by the Bank of England was also undertaken in 2017. As announced in November, despite the severity of the stress scenario, the Group exceeded the capital and leverage thresholds set out for the purpose of the stress test and was not required to take any capital action as a result.

Leverage ratio

The table below summarises the component parts of the Group’s leverage ratio. Further analysis will be provided in the Group’s Pillar 3 Report.

Table 1.33: Leverage ratio

	Fully loaded	
	At 31 Dec 2017	At 31 Dec 2016

Leverage ratio	£m	£m
Total tier 1 capital for leverage ratio		
Common equity tier 1 capital	29,647	28,899
Additional tier 1 capital	5,330	5,320
Total tier 1 capital	34,977	34,219
Exposure measure		
Statutory balance sheet assets		
Derivative financial instruments	25,834	36,138
Securities financing transactions	49,193	42,285
Loans and advances and other assets	737,082	739,370
Total assets	812,109	817,793
Qualifying central bank claims	(53,842)	(41,510)
Deconsolidation adjustments[1]		
Derivative financial instruments	(2,043)	(2,403)
Securities financing transactions	(85)	112
Loans and advances and other assets	(140,387)	(142,990)
Total deconsolidation adjustments	(142,515)	(145,281)
Derivatives adjustments		
Adjustments for regulatory netting	(13,031)	(20,490)
Adjustments for cash collateral	(7,380)	(8,432)
Net written credit protection	881	699
Regulatory potential future exposure	12,335	13,188
Total derivatives adjustments	(7,195)	(15,035)
Securities financing transactions adjustments	(2,022)	39
Off-balance sheet items	58,357	58,685
Regulatory deductions and other adjustments	(7,658)	(9,128)
Total exposure measure[2]	657,234	665,563
Average exposure measure[4]	660,557	
UK Leverage ratio[2,3,6]	5.3%	5.1%
Average UK leverage ratio[4]	5.4%	
CRD IV exposure measure[5]	711,076	707,073
CRD IV leverage ratio[5]	4.9%	4.8%

1 Deconsolidation adjustments relate to the deconsolidation of certain Group entities that fall outside the scope of the Group's regulatory capital consolidation, being primarily the Group's Insurance business.

2 Calculated in accordance with the UK Leverage Ratio Framework which requires qualifying central bank claims to be excluded from the leverage exposure measure.

3 The countercyclical leverage ratio buffer is currently nil.

4 The average UK leverage ratio is based on the average of the month end tier 1 capital and exposure measures over the quarter (1 October 2017 to 31 December 2017). The average of 5.4 per cent compares to 5.4 per cent at the start and 5.3 per cent at the end of the quarter.

5 Calculated in accordance with CRD IV rules which include central bank claims within the leverage exposure measure.

6 The UK leverage ratio is 5.4 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2018 in relation to its 2017 earnings (31 December 2016: 5.2 per cent on an adjusted basis).

Key movements

The Group's fully loaded UK leverage ratio increased by 0.2 per cent to 5.3 per cent reflecting the impact of both the increase in tier 1 capital and the £8.3 billion reduction in the exposure measure, the latter largely reflecting the underlying reduction in balance sheet assets (net of qualifying central bank claims and deconsolidation adjustments) driven by the reductions in both available-for-sale financial assets and derivatives assets, partially offset by the increase in loans and advances following the acquisition of MBNA and an increase in securities financing transactions (SFT) activity.

The derivatives exposure measure, representing derivative financial instruments per the balance sheet net of deconsolidation and derivatives adjustments, reduced by £2.1 billion during the year, primarily driven by market movements and a reduction in position levels.

The £4.7 billion increase in the SFT exposure measure during the year, representing SFT assets per the balance sheet net of deconsolidation and other SFT adjustments, reflected an increase in customer volumes, partially offset by reduced trading volumes and an increase in eligible netting adjustments.

Off-balance sheet items reduced by £0.3 billion during the year, primarily reflecting a net reduction in securitisation financing facility commitments together with corporate facility drawdowns, reductions and exits, largely offset by an increase in unconditionally cancellable credit card commitments following the acquisition of MBNA and new residential mortgage offers placed.

The average UK leverage ratio of 5.4 per cent over the quarter reflected a strengthening tier 1 capital position prior to the accrual for the announced full year ordinary dividend and further conduct provisions, and the reduction in underlying balance sheet assets during the quarter, net of qualifying central bank claims.

G-SIB indicators

Although the Group is not currently classified as a Global Systemically Important Bank (G-SIB), by virtue of the Group's leverage exposure measure exceeding €200 billion the Group is required to report G-SIB indicator metrics to the PRA. The Group's indicator metrics used within the 2017 Basel G-SIBs annual exercise will be disclosed in April 2018 and the results are expected to be made available by the Basel Committee later this year.

Insurance businesses

The business transacted by the insurance companies within the Group comprises both life insurance business and General Insurance business. Life insurance business comprises unit-linked business, non-profit business and with-profits business.

Scottish Widows Limited (SW Ltd) holds the only with-profit funds managed by the Group. Each insurance company within the Group is regulated by the PRA.

The Solvency II regime for insurers and insurance groups came into force from 1 January 2016. The insurance businesses are required to calculate solvency capital requirements and available capital on a risk-based approach. The Insurance business of the Group calculates regulatory capital on the basis of an internal model, which was approved by the PRA on 5 December 2015.

The minimum required capital must be maintained at all times throughout the year. These capital requirements and the capital available to meet them are regularly estimated in order to ensure that capital maintenance requirements are being met.

All minimum regulatory requirements of the insurance companies have been met during the year.

FUNDING AND LIQUIDITY RISK

DEFINITION

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding. Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due.

EXPOSURE

Liquidity exposure represents the potential stressed outflows in any future period less expected inflows. The Group considers liquidity from both an internal and a regulatory perspective.

MEASUREMENT

Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturities with behavioural overlays as appropriate. Note 51 on page F-78 sets out an analysis of assets and liabilities by relevant maturity grouping. Additionally the Group undertakes quantitative and qualitative analysis of behavioural aspects of its assets and liabilities in order to reflect their expected behaviour.

MITIGATION

Group Corporate Treasury (GCT) is responsible for managing and monitoring liquidity risks on behalf of the Group and ensuring that liquidity risk management systems and arrangements are adequate with regard to the internal risk appetite and Group strategy. Liquidity policies and procedures are subject to independent internal oversight by Risk. Overseas branches and subsidiaries of the Group may also be required to meet the liquidity requirements of the entity's domestic country. Management of liquidity requirements is performed by the overseas branch or subsidiary and overseen by GCT. Liquidity risk of the Insurance business is actively managed and monitored within the Insurance business. The Group plans funding requirements over the life of the funding plan, combining business as usual and stressed conditions. The Group manages its risk appetite and liquidity position with regard to its internal risk appetite and the Liquidity Coverage Ratio (LCR) required by the PRA and Capital Requirements Directive and Regulation (CRD IV) liquidity requirements.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and is supported by strong relationships across customer segments. The Group has consistently observed that in aggregate the retail deposit base provides a stable source of funding. Funding concentration by counterparty, currency and tenor is monitored on an ongoing basis and where concentrations do exist, these are managed as part of the planning process and limited by internal risk appetite, with analysis regularly provided to senior management.

To assist in managing the balance sheet the Group operates a Liquidity Transfer Pricing (LTP) process which: allocates relevant interest expenses from the centre to the Group's banking businesses within the internal management accounts; helps drive the correct inputs to customer pricing; and is consistent with regulatory requirements. LTP makes extensive use of behavioural maturity profiles, taking account of expected customer loan prepayments and stability of customer deposits, modelled on historic data.

The Group can monetise liquid assets quickly, either through the repurchase agreements (repo) market or through outright sale. In addition, the Group has pre-positioned a substantial amount of assets at the Bank of England's Discount Window Facility which can be used to access additional liquidity in a time of stress. The Group considers diversification across geography, currency, markets and tenor when assessing appropriate holdings of liquid assets. The liquid asset buffer is managed under the control of Group Corporate Treasury and is available for deployment at immediate notice, subject to complying with regulatory requirements.

Liquidity risk within the Insurance business may result from: the inability to sell financial assets quickly at their fair values; an insurance liability falling due for payment earlier than expected; the inability to generate cash inflows as anticipated; an unexpected large operational event; or from a general insurance catastrophe e.g. a significant weather event. Following the implementation of Solvency II, the annuity portfolio is ring-fenced and assets held to match annuity liability cashflows are excluded from shareholder liquidity. In the event a liquidity shortfall arises on the annuity portfolio, shareholder liquidity will be required to support this. As a result, the shareholder's exposure to liquidity risk is through Insurance's non-annuity and surplus assets, any shortfall arising in the annuity portfolio and the investment portfolios within the general Insurance business. Liquidity risk is actively managed and monitored within the Insurance business to ensure that, even under stress conditions, there is sufficient liquidity to meet obligations and remain within approved risk appetite.

MONITORING

Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group. This captures regulatory metrics as well as metrics the Group considers relevant for its liquidity profile. These are a mixture of quantitative and qualitative measures, including: daily variation of customer balances; changes in maturity profiles; cash outflows; funding concentration; changes in LCR eligible liquidity portfolio; credit default swap (CDS) spreads; and changing funding costs.

The Group carries out internal stress testing of its liquidity and potential cash flow mismatch position over both short (up to one month) and longer term horizons against a range of scenarios forming an important part of the internal risk appetite. The scenarios and assumptions are reviewed at least annually to ensure that they continue to be relevant to the nature of the business including reflecting emerging horizon risks to the Group, such as the UK exit from the EU.

For further information on the Group's 2017 liquidity stress testing results refer to page 98.

The Group maintains a Contingency Funding Plan which is designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing. Contingency Funding Plan invocation and escalation processes are based on analysis of five major quantitative and qualitative components, comprising assessment of: early warning indicators; prudential and regulatory liquidity risk limits and triggers; stress testing results; event and systemic indicators; and market intelligence.

Funding and liquidity management in 2017

The Group has maintained its strong funding and liquidity position with a loan to deposit ratio of 110 per cent at 31 December 2017 (109 per cent as at 31 December 2016).

During 2017, the Group drew down a further £15.4 billion under the Bank of England's Term Funding Scheme (TFS), now fully utilised at £20 billion as at 31 December 2017. The amount outstanding under the Bank of England's Funding for Lending Scheme (FLS) is £25.1 billion as at 31 December 2017 (£30.1 billion as at 31 December 2016).

As a result, wholesale funding has decreased by £9.7 billion to £101.1 billion as at 31 December 2017, with the amount maturing in less than one year falling to £28.5 billion as at 31 December 2017 (£35.1 billion as at 31 December 2016). In 2017, the Group issued term funding of £10.2 billion and following the full utilisation of the TFS, would expect term issuance volumes in 2018 to return to a steady-state requirement of between £15 billion and £20 billion per annum.

The Group's strong balance sheet and funding and liquidity position has been reflected in positive movements in the Group's credit ratings in 2017. During the second half of the year, Moody's upgraded Lloyds Bank plc's long-term rating by one notch to 'Aa3'. In addition, S&P improved Lloyds Bank plc's outlook to 'positive' to reflect the Group's improved bail-in capital position following recent Lloyds Banking Group plc issuance.

The Group's liquidity surplus continues to exceed the regulatory minimum and internal risk appetite, with a Liquidity Coverage Ratio of 127 per cent as at 31 December 2017 based on the EU Delegated Act.

Table 1.34: Summary funding and liquidity metrics

	At 31 Dec 2017 £bn	At 31 Dec 2016 £bn	Change (%)
LCR eligible assets	**120.9**	120.8	–
Loan to deposit ratio (%)	**109.7**	108.9	1
LCR eligible liquid assets/money market funding less than one year maturity (x)[1]	**8.3**	8.8	(6)

1 Excludes balances relating to margins of £2.1 billion (31 December 2016: £3.2 billion) and settlement accounts of £1.5 billion (31 December 2016: £1.8 billion).

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Table 1.35: Group funding position

	At 31 Dec 2017 £bn	At 31 Dec 2016 £bn	*Change %*
Funding requirement			
Loans and advances to customers[1]	455.7	449.7	1
Loans and advances to banks[2]	4.1	5.1	(20)
Debt securities	3.6	3.4	6
Reverse repurchase agreements	0.7	0.5	40
Available-for-sale financial assets – non-LCR eligible[3]	0.9	1.9	(53)
Cash and balances at central bank – non-LCR eligible[4]	4.8	4.8	–
Funded assets	469.8	465.4	1
Other assets[5]	234.7	249.9	(6)
	704.5	715.3	(2)
On balance sheet LCR eligible liquid assets			
Reverse repurchase agreements	16.9	8.7	94
Cash and balances at central banks[4]	53.7	42.7	26
Available-for-sale financial assets	41.2	54.6	(25)
Trading and fair value through profit and loss	1.7	1.8	(6)
Repurchase agreements	(5.9)	(5.3)	11
	107.6	102.5	5
Total Group assets	812.1	817.8	(1)
Less: other liabilities[5]	(226.5)	(240.7)	(6)
Funding requirement	585.6	577.1	1
Funded by			
Customer deposits	415.5	413.0	1
Wholesale funding[6]	101.1	110.8	(9)
	516.6	523.8	(1)
Term funding scheme	19.9	4.5	
Total equity	49.1	48.8	1
Total funding	585.6	577.1	1

1 Excludes £16.8 billion (31 December 2016: £8.3 billion) of reverse repurchase agreements.

2 Excludes £1.7 billion (31 December 2016: £20.9 billion) of loans and advances to banks within the Insurance business and £0.8 billion (31 December 2016: £0.9 billion) of reverse repurchase agreements.

3 Non-LCR eligible liquid assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

4 Cash and balances at central banks are combined in the Group's balance sheet.

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Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

6 The Group's definition of wholesale funding aligns with that used by other international market participants, including interbank deposits, debt securities in issue and subordinated liabilities.

Table 1.36: Reconciliation of Group funding to the balance sheet (audited)

	At 31 December 2017				At 31 December 2016			
	Included in funding analysis £bn	**Repos and cash collateral received by Insurance £bn**	**Fair value and other accounting methods £bn**	**Balance sheet £bn**	Included in funding analysis £bn	Repos and cash collateral received by Insurance £bn	Fair value and other accounting methods £bn	Balance sheet £bn
Deposits from banks	**5.1**	**24.1**	**0.6**	**29.8**	8.1	8.0	0.3	16.4
Debt securities in issue	**78.1**	**–**	**(5.6)**	**72.5**	83.0	–	(6.7)	76.3
Subordinated liabilities	**17.9**	**–**	**–**	**17.9**	19.7	–	0.1	19.8
Total wholesale funding	**101.1**	**24.1**			110.8	8.0		
Customer deposits	**415.5**	**2.6**	**–**	**418.1**	413.0	2.5	–	415.5
Total	**516.6**	**26.7**			523.8	10.5		

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Table 1.37: Analysis of 2017 total wholesale funding by residual maturity

	Less than one month £bn	One to three months £bn	Three to six months £bn	Six to nine months £bn	Nine months to one year £bn	One to two years £bn	Two to five years £bn	More than five years £bn	Total at 31 Dec 2017 £bn	Total at 31 Dec 2016 £bn
Deposit from banks	3.7	1.0	0.3	0.1	–	–	–	–	5.1	8.1
Debt securities in issue:										
Certificates of deposit	1.3	2.1	3.2	2.5	0.9	–	–	–	10.0	7.5
Commercial paper	0.4	2.8	–	–	–	–	–	–	3.2	3.2
Medium-term notes[1]	0.7	0.6	0.5	0.9	2.3	3.0	12.1	17.3	37.4	36.9
Covered bonds	1.5	–	0.7	0.1	–	2.8	12.3	7.3	24.7	29.1
Securitisation	–	0.4	–	0.1	0.1	0.6	1.3	0.3	2.8	6.3
	3.9	5.9	4.4	3.6	3.3	6.4	25.7	24.9	78.1	83.0
Subordinated liabilities	–	0.2	1.5	–	0.6	0.5	3.2	11.9	17.9	19.7
Total wholesale funding[2]	7.6	7.1	6.2	3.7	3.9	6.9	28.9	36.8	101.1	110.8
Of which issued by Lloyds Banking Group plc[3]	–	–	–	–	–	–	4.4	11.0	15.4	7.4

1 Medium-term notes include funding from the National Loan Guarantee Scheme (31 December 2016: £1.4 billion), which matured during 2017.

2 The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

3 Consists of medium-term notes only.

Table 1.38: Total wholesale funding by currency (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2017	25.8	32.1	37.0	6.2	101.1
At 31 December 2016	30.6	33.0	41.4	5.8	110.8

Table 1.39: Analysis of 2017 term issuance (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	–	–	–	–	–
Medium-term notes	1.0	5.2	1.6	1.0	8.8
Covered bonds	1.0	–	–	–	1.0
Private placements[1]	0.1	0.3	–	–	0.4
Subordinated liabilities	–	–	–	–	–
Total issuance	2.1	5.5	1.6	1.0	10.2
Of which issued by Lloyds Banking Group plc[2]	1.0	5.2	1.6	1.0	8.8

1 Private placements include structured bonds and term repurchase agreements (repos).

2 Consists of medium-term notes only.

The Group continues to maintain a diversified approach to funding markets with trades in public and private format, secured and unsecured products and a wide range of currencies and markets. For 2018, the Group will continue to maintain this diversified approach to funding, including capital and funding from the holding company, Lloyds Banking Group plc, as needed to transition towards final UK Minimum Requirements for Own Funds and Eligible Liabilities (MREL). The contractual maturities for the FLS and TFS are fully factored into the Group's funding plan.

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Liquidity portfolio

At 31 December 2017, the banking business had £120.9 billion of highly liquid unencumbered LCR eligible assets (31 December 2016: £120.8 billion), of which £120.2 billion is LCR level 1 eligible (31 December 2016: £120.3 billion) and £0.7 billion is LCR level 2 eligible (31 December 2016: £0.5 billion). These assets are available to meet cash and collateral outflows and PRA regulatory requirements. A separate liquidity portfolio to mitigate any insurance liquidity risk is managed within the Insurance business. LCR eligible liquid assets represent over eight times the Group's money market funding less than one year to maturity (excluding derivative collateral margins and settlement accounts) and exceed total wholesale funding, and thus provide a substantial buffer in the event of market dislocation. As previously communicated, given the economic climate, the Group does not expect to hold gilts to maturity. The Group has therefore continued to reduce the size of its gilts portfolio owned outright.

Table 1.40: LCR eligible assets

	At 31 Dec 2017 £bn	At 31 Dec 2016 £bn	*Change* %	**Unweighted average 2017 £bn**	Unweighted average 2016 £bn
Level 1					
Cash and central bank reserves	53.7	42.7	26	51.0	53.7
High quality government/MDB/agency bonds[1]	65.8	75.3	(13)	72.0	72.4
High quality covered bonds	0.7	2.3	(70)	1.1	2.4
Total	120.2	120.3	–	124.1	128.5
Level 2[2]	0.7	0.5	40	0.6	0.5
Total LCR eligible assets	120.9	120.8	–	124.7	129.0

1 Designated multilateral development bank (MDB).

2 Includes Level 2A and Level 2B.

Table 1.41: LCR eligible assets by currency

	Sterling £bn	**US Dollar £bn**	**Euro £bn**	**Other currencies £bn**	**Total £bn**
At 31 December 2017					
Level 1	90.8	16.3	13.1	–	120.2
Level 2	0.2	0.5	–	–	0.7
Total	91.0	16.8	13.1	–	120.9

At 31 December 2016					
Level 1	96.0	12.5	11.8	–	120.3
Level 2	0.2	0.3	–	–	0.5
Total	96.2	12.8	11.8	–	120.8

The banking business also has a significant amount of non-LCR eligible assets which are eligible for use in a range of central bank or similar facilities. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

Stress testing results

Internal stress testing results at 31 December 2017 showed that the banking business had liquidity resources representing 142 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intraday requirements and rating dependent contracts under the Group's most severe liquidity stress scenario.

A hypothetical idiosyncratic two notch downgrade of the Group's current long-term debt rating and accompanying short-term downgrade implemented instantaneously by all major rating agencies, could result in a contractual outflow of £1.1 billion of cash over a period of up to one year, £2.0 billion of collateral posting related to customer financial contracts and £5.9 billion of collateral posting associated with secured funding.

Encumbered assets

This disclosure provides further detail on the availability of assets that could be used to support potential future funding requirements of the Group. The disclosure is not designed to identify assets that would be available in the event of a resolution or bankruptcy.

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The Board and the Group Asset and Liability Committee (GALCO) monitor and manage total balance sheet encumbrance via a number of risk appetite metrics. At 31 December 2017, the Group had £64.6 billion (31 December 2016: £83.5 billion) of externally encumbered on balance sheet assets with counterparties other than central banks. The decrease in encumbered assets was primarily driven by maturities of covered bond and securitisation issuances. The Group also had £587.5 billion (31 December 2016: £580.9 billion) of unencumbered on balance sheet assets, and £160.1 billion (31 December 2016: £153.5 billion) of pre-positioned and encumbered assets held with central banks. Primarily the Group encumbers mortgages, unsecured lending and credit card receivables through the issuance programmes and tradable securities through securities financing activity. The Group mainly positions mortgage assets at central banks.

Table 1.42: On balance sheet encumbered and unencumbered assets

	Encumbered with counterparties other than central banks				Pre-positioned and encumbered assets held with central banks £m	**Unencumbered assets not pre-positioned with central banks**				
	Securitisations £m	Covered bond £m	Other £m	Total £m		Readily realisable[1] £m	**Other realisable assets[2] £m**	**Cannot be used[3] £m**	Total £m	Total £m
At 31 December 2017										
Cash and balances at central banks	–	–	–	–	–	53,887	–	4,634	58,521	58,521
Trading and other financial assets at fair value through profit or loss	–	–	4,642	4,642	–	7,378	–	150,858	158,236	162,878
Derivative financial instruments	–	–	–	–	–	–	–	25,834	25,834	25,834
Loans and receivables:										
Loans and advances to banks	–	–	–	–	–	213	1,417	4,981	6,611	6,611
Loans and advances to customers	5,023	26,414	6,610	38,047	160,060	13,927	170,771	89,693	274,391	472,498
Debt securities	–	–	2,374	2,374	–	919	4	346	1,269	3,643
	5,023	26,414	8,984	40,421	160,060	15,059	172,192	95,020	282,271	482,752
	–	–	19,526	19,526	–	21,514	–	1,058	22,572	42,098

Available-for-sale financial assets										
Other[4]	–	–	–	–	–	16	1,175	38,835	40,026	40,026
Total assets	5,023	26,414	33,152	64,589	160,060	97,854	173,367	316,239	587,460	812,109
At 31 December 2016										
Cash and balances at central banks	–	–	–	–	–	42,998	–	4,454	47,452	47,452
Trading and other financial assets at fair value through profit or loss	–	–	4,806	4,806	–	9,175	22	137,171	146,368	151,174
Derivative financial instruments	–	–	–	–	–	–	–	36,138	36,138	36,138
Loans and receivables:										
Loans and advances to banks	–	–	32	32	–	528	1,825	24,517	26,870	26,902
Loans and advances to customers	14,542	30,883	7,305	52,730	153,482	7,032	152,997	91,717	251,746	457,958
Debt securities	–	–	904	904	–	2,344	5	144	2,493	3,397
	14,542	30,883	8,241	53,666	153,482	9,904	154,827	116,378	281,109	488,257
Available-for-sale financial assets	154	–	24,824	24,978	–	31,017	31	498	31,546	56,524
Other[4]	–	–	–	–	–	34	1,737	36,477	38,248	38,248
Total assets	14,696	30,883	37,871	83,450	153,482	93,128	156,617	331,116	580,861	817,793

1 Assets regarded by the Group to be readily realisable in the normal course of business, to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, and are not subject to any restrictions on their use for these purposes.

2 Assets where there are no restrictions on their use to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, but are not readily realisable in the normal course of business in their current form.

3 The following assets are classified as unencumbered – cannot be used: assets held within the Group's Insurance businesses which are generally held to either back liabilities to policyholders or to support the solvency of the Insurance subsidiaries; assets held within consolidated limited liability partnerships which provide security for the Group's obligations to its pension schemes; assets pledged to facilitate the use of intra-day payment and settlement systems; and reverse repos and derivatives balance sheet ledger items.

4 Other comprises: items in the course of collection from banks; investment properties; goodwill; value in-force business; other intangible assets; tangible fixed assets; current tax recoverable; deferred tax assets; retirement benefit assets; and other assets.

The above table sets out the carrying value of the Group's encumbered and unencumbered assets, separately identifying those that are available to support the Group's funding needs. The table does not include collateral received by the Group (i.e. from reverse repos) that is not recognised on its balance sheet, the vast majority of which the Group is permitted to repledge.

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CONTRACTUAL CASH OBLIGATIONS

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2017.

	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Long-term debt – dated	1,647	2,993	792	7,422	12,854
Debt securities in issue	21,071	17,118	15,709	26,364	80,262
Finance leases	3	4	–	12	19
Operating leases	275	378	467	934	2,054
Capital commitments	444	–	–	–	444
Other purchase obligations	1,195	1,778	1,071	707	4,751
	24,635	22,271	18,039	35,439	100,384

Other purchase obligations include amounts expected to be payable in respect of material contracts entered into by the Lloyds Banking Group, in the ordinary course of business, for the provision of outsourced and other services. The cost of these services will be charged to the income statement as it is incurred. The Lloyds Banking Group also has a constructive obligation to ensure that its defined post-retirement benefit schemes remain adequately funded. The amount and timing of the Lloyds Banking Group's cash contributions to these schemes is uncertain and will be affected by factors such as future investment returns and demographic changes. Lloyds Banking Group expects to make cash contributions of at least £750 million to these schemes in 2018.

At 31 December 2017, Lloyds Banking Group also had £5,068 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2017, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds Bank to pay dividends going forward, or for Lloyds Bank or other Lloyds Banking Group companies to make loans to Lloyds Banking Group plc, depends on a number of factors, including their own regulatory capital requirements, distributable reserves and financial performance.

OFF-BALANCE SHEET ARRANGEMENTS

A table setting out the amounts and maturities of Lloyds Banking Group's other commercial commitments at 31 December 2017 is included in note 51 to the financial statements. These commitments are not included in Lloyds Banking Group's consolidated balance sheet.

Lending commitments are agreements to lend to customers in accordance with contractual provisions; these are either for a specified period or, as in the case of credit cards and overdrafts, represent a revolving credit facility which can be drawn down at any time, provided that the agreement has not been terminated. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

Lloyds Banking Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The contractual nominal amounts of these guarantees totalled £5,820 million at 31 December 2017 (with £3,132 million expiring within one year; £627 million between one and three years; £1,471 million between three and five years; and £590 million over five years).

Lloyds Banking Group's banking businesses are also exposed to liquidity risk through the provision of securitisation facilities to certain corporate customers. At 31 December 2017, Lloyds Banking Group offered securitisation facilities to its corporate and financial institution client base through its conduit securitisation vehicles, Argento, Cancara and Grampian. These are funded in the global asset-backed commercial paper market. The assets and obligations of these conduits are included in Lloyds Banking Group's consolidated balance sheet. Lloyds Banking Group provides short-term asset-backed commercial paper liquidity support facilities on commercial terms to the issuers of the commercial paper, for use in the event of a market disturbance should they be unable to roll over maturing commercial paper or obtain alternative sources of funding.

Details of securitisations and other special purpose entity arrangements entered into by the Group are provided in notes 18 and 19 to the financial statements. The successful development of Lloyds Banking Group's ability to securitise its own assets has provided a mechanism to tap a well established market, thereby diversifying Lloyds Banking Group's funding base.

Within Lloyds Banking Group's insurance businesses, the principal sources of liquidity are premiums received from policyholders, charges levied upon policyholders, investment income and the proceeds from the sale and maturity of investments. The investment policies followed by Lloyds Banking Group's life assurance companies take account of anticipated cash flow requirements including by matching the cash inflows with projected liabilities where appropriate. Cash deposits and highly liquid government securities are available to provide liquidity to cover any higher than expected cash outflows.

GOVERNANCE RISK

DEFINITION

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

EXPOSURES

The internal and corporate governance arrangements of major financial institutions continue to be subject to a high level of regulatory and public scrutiny. The Group's exposure to governance risk is also reflective of the significant volume of existing and proposed legislation and regulation, both within the UK and across the multiple jurisdictions within which it operates, with which it must comply. Risk governance and risk culture are mutually reinforcing.

MEASUREMENT

The Group's governance arrangements are assessed against new or proposed legislation and regulation and best practice among peer organisations in order to identify any areas of enhancement required.

MITIGATION

The Group's Risk Management Framework (RMF) establishes robust arrangements for risk governance, in particular by:

– Defining individual and collective accountabilities for risk management, risk oversight and risk assurance through a three lines of defence model which supports the discharge of responsibilities to customers, shareholders and regulators;

– Outlining governance arrangements which articulate the enterprise-wide approach to risk management; and

– Supporting a consistent approach to Group-wide behaviour and risk decision making through a Group policy framework which helps everyone understand their responsibilities by clearly articulating and communicating rules, standards, boundaries and risk appetite measures which can be controlled, enforced and monitored.

Under the banner of the RMF, training modules are in place to support all colleagues in understanding and fulfilling their risk responsibilities.

The Ethics and Responsible Business Policy and supporting code of responsibility embody the Group's values and reflect its commitment to operating responsibly and ethically both at a business and an individual level. All colleagues are required to adhere to the code in all aspects of their roles.

Effective implementation of the RMF mutually reinforces and is reinforced by the Group's risk culture, which is embedded in its approach to recruitment, selection, training, performance management and reward.

MONITORING

A review of the Group's RMF, which includes the status of the Group's principles and policy framework, and the design and operational effectiveness of key governance committees, is undertaken on an annual basis and the findings are reported to the Group Risk Committee, Board Risk Committee and the Board.

This includes a review of the Group's current approach to governance and ongoing initiatives in light of the latest regulatory guidance, including in 2017 the continued enhancement of frameworks to address Senior Managers and Certification Regime (SM&CR) requirements and prepare for the requirement to ring-fence retail banking activities with effect from January 2019.

For further information on Corporate Governance see pages 138–164.

MARKET RISK

DEFINITION

Market risk is defined as the risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments) lead to reductions in earnings and/or value.

Balance sheet linkages

The information provided in table 1.43 aims to facilitate the understanding of linkages between banking, trading, and insurance balance sheet items and the positions disclosed in the Group's market risk disclosures.

Table 1.43: Market risk linkage to the balance sheet

2017	Total £m	Banking Trading book only £m	Non-trading £m	Insurance £m	Primary market risk factor
Assets					
Cash and balances at central banks	**58,521**	**–**	**58,521**	**–**	Interest rate
Trading and other financial assets at fair value through profit or loss	**162,878**	**42,230**	**3,325**	**117,323**	Interest rate, foreign exchange, credit spread
Derivative financial instruments	**25,834**	**21,605**	**1,881**	**2,348**	Interest rate, foreign exchange, credit spread
Loans and receivables					
Loans and advances to banks	**6,611**	**–**	**4,274**	**2,337**	Interest rate
Loans and advances to customers[1]	**472,498**	**–**	**472,498**	**–**	Interest rate
Debt securities	**3,643**	**–**	**3,643**	**–**	Interest rate, credit spread
	482,752	**–**	**480,415**	**2,337**	
Available-for-sale financial assets	**42,098**	**–**	**42,098**	**–**	Interest rate, foreign exchange, credit spread
Value of in-force business	**4,839**	**–**	**–**	**4,839**	Equity
Other assets	**35,187**	**–**	**18,303**	**16,884**	Interest rate
Total assets	**812,109**	**63,835**	**604,543**	**143,731**	
Liabilities					
Deposit from banks	**29,804**	**–**	**29,804**	**–**	Interest rate
Customer deposits	**418,124**	**–**	**418,124**	**–**	Interest rate

Trading and other financial liabilities at fair value through profit or loss	**50,877**	**43,062**	**7,815**	**–**	Interest rate, foreign exchange
Derivative financial instruments	**26,124**	**21,699**	**1,613**	**2,812**	Interest rate, foreign exchange, credit spread
Debt securities in issue	**72,450**	**–**	**72,450**	**–**	Interest rate, credit spread
Liabilities arising from insurance and investment contracts	**118,860**	**–**	**–**	**118,860**	Credit spread
Subordinated liabilities	**17,922**	**–**	**16,131**	**1,791**	Interest rate, foreign exchange
Other liabilities	**28,805**	**–**	**8,345**	**20,460**	Interest rate
Total liabilities	**762,966**	**64,761**	**554,282**	**143,923**	

1 Includes £6.9 billion of lower risk loans within the banking book sold by Commercial Banking and Retail to Insurance to manage market risk arising from annuitant liabilities within the Insurance business.

The defined benefit pension schemes' assets and liabilities are included under Other assets and Other liabilities in this table and note 35 on page F-44 provides further information.

The Group's trading book assets and liabilities are originated by Commercial Banking (CB) Markets within the Commercial Banking division. Within the Group's balance sheet these fall under the trading assets and liabilities and derivative financial instruments. The assets and liabilities are classified as trading books if they have been acquired or incurred for the purpose of selling or repurchasing in the near future. These consist of government, corporate and financial institution bonds and loans/deposits and repos. Further information on these activities can be found under the Trading portfolios section on page 107.

Derivative assets and liabilities are held by the Group for three main purposes; to provide risk management solutions for clients, to manage portfolio risks arising from client business and to manage and hedge the Group's own risks. The majority of derivatives exposure arises within CB Markets. Insurance business assets and liabilities relate to policyholder funds, as well as shareholder invested assets, including annuity funds. The Group recognises the value of in-force business in respect of Insurance's long-term life assurance contracts as an asset in the balance sheet (see note 24, page F-36).

The Group ensures that it has adequate cash and balances at central banks and stocks of high quality liquid assets (e.g. gilts or US Treasury securities) that can be converted easily into cash to meet liquidity requirements. The majority of these assets are held as available-for-sale with the remainder held as financial assets at fair value through profit and loss. Further information on these balances can be found under Funding and liquidity risk on page 94. Interest rate risk in the asset portfolios is swapped into a floating rate.

The majority of debt issuance originates from the issuance, capital vehicles and medium term notes desks and the interest rate risk of the debt issued is hedged by swapping them into a floating rate.

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The non-trading book primarily consists of customer on balance sheet activities and the Group’s capital and funding activities, which expose it to the risk of adverse movements in market prices, predominantly interest rates, credit spreads, exchange rates and equity prices, as described in further detail within the Banking activities section below.

Table 1.44 below shows the key material market risks for the Group’s banking, defined benefit pension schemes, insurance and trading activities.

Table 1.44: Key material market risks for the Group by individual business activity (profit before tax impact measured against Group single stress scenarios)

	Risk Type					
2017	**Interest Rate**	**Basis Risk**	**FX**	**Credit Spread**	**Equity**	**Inflation**
Banking activities[1]		–	–			–
Defined benefit pension schemes[1]		–	–			–
Insurance portfolios[1]		–	–			–
Trading portfolios[2]	–	–	–	–	–	–

Profit before tax	**Loss**	**Gain**
> £500m		
£250m – £500m		
£50m – <£250m		
Immaterial/zero	–	–

1 Banking activities, Pensions and Insurance stresses; Interest rate -100 bps, Basis Risk 3 month London Interbank Offered Rate (LIBOR) +100bps/bank base rate -25bps, Foreign Exchange (FX) -15 per cent GBP, Credit Spread +100 per cent, Equity -30 per cent, Inflation +50 bps

2 Trading Portfolios; Interest rate +30bps, FX +5 per cent GBP, Credit Spread +20 per cent, Inflation +50bps.

MEASUREMENT

In addition to measuring single factors, Group risk appetite is calibrated primarily to five multi-risk Group economic scenarios, and is supplemented with sensitivity based measures. The scenarios assess the impact of unlikely, but plausible adverse stresses on income, with the worst case for banking activities, defined benefit pensions, insurance and trading portfolios reported against independently, and across the Group as a whole.

The Group risk appetite is cascaded first to the Group Asset and Liability Committee (GALCO), chaired by the Chief Financial Officer, where risk appetite is approved and monitored by risk type, and then to Group Market Risk Committee (GMRC) where risk appetite is sub allocated by division. These metrics are reviewed regularly by senior management to inform effective decision making.

MITIGATION

GALCO is responsible for approving and monitoring Group market risks, management techniques, market risk measures, behavioural assumptions, and the market risk policy. Various mitigation activities are assessed and undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits. The mitigation actions will vary dependent on exposure, but will, in general, look to reduce risk in a cost effective manner, by offsetting balance sheet exposures and externalising through to the financial markets dependent on market liquidity. The market risk policy is owned by Group Corporate Treasury (GCT) and refreshed annually. The policy is underpinned by supplementary market risk procedures, which define specific market risk management and oversight requirements.

MONITORING

GALCO and the GMRC regularly review high level market risk exposure, as part of the wider risk management framework. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and Group Market Risk Policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits and triggers are monitored by Risk and where appropriate, escalation procedures are in place.

How market risks arise and are managed across the Group’s activities is considered in more detail below.

Banking activities

Exposures

The Group’s banking activities expose it to the risk of adverse movements in market prices, predominantly interest rates, credit spreads, exchange rates and equity prices. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset or liability.

INTEREST RATE RISK

Yield curve risk in the Group's divisional portfolios, and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets, liabilities (see loans and advances to customers and customer deposits in table 1.43) and off balance sheet positions.

Basis risk arises from the possible changes in spreads, for example where the bank lends with reference to a central bank rate but funds with reference to LIBOR, and the spread between these two rates widens or tightens.

Optionality risk arises predominantly from embedded optionality within assets, liabilities or off-balance sheet items where either the Group or the customer can affect the size or timing of cash flows. One example of this risk is pipeline mortgage risk where the customer owns an option on a mortgage rate and changes in market rates can impact the take up of the committed offer. Mortgage prepayment risk is another example where the customer owns an option allowing them to prepay when it is economical to do so. This can result in customer balances amortising more quickly or slowly than anticipated due to economic conditions or customers' response to changes in economic conditions.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

FOREIGN EXCHANGE RISK

Economic foreign exchange exposure arises from the Group's investment in its overseas operations (net investment exposures are disclosed in note 51 on page F-78). In addition, the Group incurs foreign exchange risk through non-functional currency flows from services provided by customer facing divisions and the Group's debt and capital management programmes.

EQUITY RISK

Equity risk arises primarily from three different sources: (i) the Group's strategic equity holdings in Banco Sabadell, Aberdeen Asset Management, and Visa Europe; (ii) exposure to Lloyds Banking Group share price through deferred shares and deferred options granted to employees as part of their benefits package; and (iii) the Group's private equity investments held by Lloyds Development Capital.

CREDIT SPREAD RISK

Credit spread risk arises largely from: (i) the liquid asset portfolio held in the management of Group liquidity, comprising of government, supranational, and other eligible assets; (ii) the Credit Valuation Adjustment (CVA) and Debit Valuation Adjustment (DVA) sensitivity to credit spreads; and (iii) a number of the Group's structured medium term notes where its has elected to fair value the notes through the profit and loss account.

Measurement

Interest rate risk exposure is monitored monthly using, primarily:

(i) Market value sensitivity: this methodology considers all repricing mismatches (behaviourally adjusted where appropriate) in the current balance sheet and calculates the change in market value that would result from an instantaneous 25, 100 and 200 basis points parallel rise or fall in the yield curve (subject to an appropriate floor). The market value sensitivities are calculated on a static balance sheet using principal cash flows excluding commercial margins and other spread components and are therefore discounted at the risk free zero-coupon rate.

(ii) Interest income sensitivity: this measures the 12 month impact on future net interest income arising from various economic scenarios. These include instantaneous 25, 100 and 200 basis point parallel shifts in all yield curves and the five Group economic scenarios (subject to an appropriate floor). These scenarios are reviewed every year and are designed to replicate severe but plausible economic events, capturing risks that would not be evident through the use of parallel shocks alone such as basis risk and steepening or flattening of the yield curve. An additional negative rates scenario is also used for information purposes where all floors are removed; however this is not measured against the limit framework.

Unlike the market value sensitivities, the interest income sensitivities incorporate additional behavioural assumptions as to how and when individual products would reprice in response to changing rates. In addition a dynamic balance sheet is used which includes the run-off of current assets and liabilities and the addition of planned new business.

Reported sensitivities are not necessarily predictive of future performance as they do not capture additional management actions that would likely be taken in response to an immediate, large, movement in interest rates. The actions could reduce the net interest income sensitivity and help mitigate any adverse impacts or they may result in changes to total income that are not captured in the net interest income.

(iii) Market value limit: this caps the amount of conventional and inflation-linked government bonds held by the Group for liquidity purposes.

(iv) Structural hedge limits: these metrics enhance understanding of assumption and duration risk taken within the behaviouralisation of this portfolio.

The Group has an integrated Asset and Liability Management (ALM) system which supports non traded asset and liability management of the Group. This provides a single consolidated tool to measure and manage interest rate repricing profiles (including behavioural assumptions), perform stress testing and produce forecast outputs. The Group is aware that any assumptions based model is open to challenge. A full behavioural review is performed annually, or in response to changing market conditions, to ensure the assumptions remain appropriate and the model itself is subject to annual re-validation, as required under the Group Model Governance Policy. The key behavioural assumptions are: (i) embedded optionality within products; (ii) the duration of balances that are contractually repayable on demand, such as current accounts and overdrafts, together with net free reserves of the Group; and (iii) the re-pricing behaviour of managed rate liabilities namely variable rate savings.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group’s risk appetite.

Table 1.45 below shows, split by material currency, the Group's market value sensitivities to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.45: Banking activities: market value sensitivity

	2017				2016			
	Up 25bps £m	**Down 25bps £m**	**Up 100bps £m**	**Down 100bps £m**	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Sterling	**(9.9)**	**10.1**	**(38.7)**	**22.1**	(11.4)	11.5	(45.1)	31.6
US Dollar	**(3.6)**	**3.7**	**(14.2)**	**15.3**	3.2	(3.2)	12.6	(13.7)
Euro	**2.2**	**(0.7)**	**8.9**	**0.9**	(6.0)	(3.7)	(23.2)	(12.1)
Other	**(0.1)**	**0.2**	**(0.5)**	**0.6**	(0.2)	0.2	(0.9)	0.6
Total	**(11.4)**	**13.3**	**(44.5)**	**38.9**	(14.4)	4.8	(56.6)	6.4

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The market value sensitivity is driven by temporary customer flow positions not yet hedged plus other positions occasionally held, within limits, by the Group's wholesale funding desks in order to minimise overall funding and hedging costs. The level of risk is low relative to the size of the total balance sheet.

Table 1.46 below shows supplementary value sensitivity to a steepening and flattening (c. 100 basis points around the 3 year point) in the yield curve. This ensures there are no unintended consequences to managing risk to parallel shifts in rates.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.46: Banking activities: market value sensitivity to a steepening and flattening of the yield curve

	2017		2016	
	Steepener	**Flattener**	Steepener	Flattener
	£m	**£m**	£m	£m
Sterling	**(1.1)**	**(16.5)**	(5.8)	(13.2)
US Dollar	**7.1**	**(8.9)**	0.7	(1.3)
Euro	**(3.8)**	**7.9**	(15.3)	(12.8)
Other	**(0.2)**	**0.2**	(0.2)	0.2
Total	**2.0**	**(17.3)**	(20.6)	(27.1)

The table below shows the banking book income sensitivity to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.47: Banking activities: net interest income sensitivity

	2017				2016			
	Up 25bps	**Down 25bps**	**Up 100bps**	**Down 100bps**	Up 25bps	Down 25bps	Up 100bps	Down 100bps
	£m	**£m**	**£m**	**£m**	£m	£m	£m	£m
Client facing activity and associated hedges	**86.1**	**(54.0)**	**370.5**	**(186.9)**	176.8	(286.1)	724.9	(408.0)

Income sensitivity is measured over a rolling 12 month basis.

The reduction in the net interest income sensitivity reflects the growth in the structural hedge throughout 2017 and the accompanying reduction in income volatility in future years.

Basis risk, foreign exchange, equity, and credit spread risks are measured primarily through scenario analysis by assessing the impact on profit before tax over a 12 month horizon arising from a change in market rates, and reported within the Board risk appetite on a monthly basis. Supplementary measures such as sensitivity and exposure limits are applied where they provide greater insight into risk positions. Frequency of reporting supplementary measures varies from daily to quarterly appropriate to each risk type.

Mitigation

The Group's policy is to optimise reward whilst managing its market risk exposures within the risk appetite defined by the Board. The Group Market Risk Policy and procedures outlines the hedging process, and the centralisation of risk from divisions into GCT, e.g. via the transfer pricing framework. GCT is responsible for managing the centralised risk and does this through natural offsets of matching assets and liabilities, and appropriate hedging activity of the residual exposures, subject to the authorisation and mandate of GALCO within the Board risk appetite. Derivative desks in CB Markets will then externalise the hedges to the market. The Group has hedge accounting solutions in place, which reduce the accounting volatility arising from the Group's economic hedging activities by utilising both LIBOR based and bank base rate assets.

The largest residual risk exposure arises from balances that are deemed to be insensitive to changes in market rates (including current accounts, a portion of variable rate deposits and investable equity), and is managed through the Group's structural hedge. Consistent with the Group's strategy to deliver stable returns, GALCO seeks to minimise large reinvestment risk, and to smooth earnings over a range of investment tenors. The structural hedge consists of longer term fixed rate assets or interest rate swaps and the amount and duration of the hedging activity is reviewed regularly by GALCO.

Whilst the bank faces margin compression in the current low rate environment, its exposure to pipeline and prepayment risk are not considered material, and are hedged in line with expected customer behaviour. These are appropriately monitored and controlled through divisional Asset and Liability Committees (ALCOs).

Net investment foreign exchange exposures are managed centrally by GCT, by hedging non-sterling asset values with currency borrowing. In the first half of 2017, the Group unwound the economic hedges against these positions in order to create additional offset to common equity tier 1 (CET1) movements arising from revaluation of foreign currency risk-weighted assets (see note 51 on page F-78). Economic foreign exchange exposures arising from non-functional currency flows are identified by divisions and transferred and managed centrally. The Group also has a policy of forward hedging its forecasted currency profit and loss to year end.

Monitoring

The appropriate limits and triggers are monitored by senior executive committees within the banking divisions. Banking assets, liabilities and associated hedging are actively monitored and if necessary rebalanced to be within agreed tolerances.

Defined benefit pension schemes

Exposures

The Group's defined benefit pension schemes are exposed to significant risks from their assets and liabilities. The liability discount rate provides exposure to interest rate risk and credit spread risk, which are partially offset by fixed interest assets (such as gilts and corporate bonds) and swaps. Equity and alternative asset risk arises from direct asset holdings. Scheme membership provides exposure to longevity risk.

For further information on defined benefit pension scheme assets and liabilities please refer to note 35 on page F-44.

Measurement

Management of the schemes' assets is the responsibility of the Trustees of the schemes who are responsible for setting the investment strategy and for agreeing funding requirements with the Group. Should a funding deficit arise, the Group will be liable for meeting it, and as part of a triennial valuation process will agree with the Trustees a funding strategy to eliminate the deficit over an appropriate period.

Longevity risk is measured using both 1-in-20 year stresses (risk appetite) and 1-in-200 year stresses (regulatory capital).

Mitigation

The Group takes an active involvement in agreeing mitigation strategies with the schemes' Trustees. An interest rate and inflation hedging programme is in place to reduce liability risk. The schemes have also reduced equity allocation and invested the proceeds in credit assets as part of a programme to de-risk the portfolio. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

Monitoring

In addition to the wider risk management framework, governance of the schemes includes two specialist pensions committees.

The surplus or deficit in the schemes is tracked on a monthly basis along with various single factor and scenario stresses which consider the assets and liabilities holistically. Key metrics are monitored monthly including the Group's capital resources of the scheme, the performance against risk appetite triggers, and the performance of the hedged asset and liability matching positions.

Insurance portfolios

Exposures

The main elements of market risk to which the Group is exposed through the Insurance business are equity, credit spread, interest rate and inflation.

- Equity risk arises indirectly through the value of future management charges on policyholder funds. These management charges form part of the value of in-force business (see note 24 on page F-36). Equity risk also arises in the with-profits funds but is less material.

- Credit spread risk mainly arises from annuities where policyholders' future cashflows are guaranteed at retirement. Exposure arises if the market value of the assets which are held to back these liabilities, mainly corporate bonds and loans, do not perform in line with expectations. Within the Group accounts a large amount of the exposure to market value movements, but not actual default losses, is removed as accounting rules require that assets which the Insurance division has acquired from Group are maintained at the original amortised book value.

- Interest rate risk arises through holding credit and interest assets mainly in the annuity book and also to cover general insurance liabilities, capital requirements and risk appetite.

- Inflation exposure arises from a combination of inflation linked policyholder benefits and inflation assumptions used to project future expenses.

Measurement

Current and potential future market risk exposures within Insurance are assessed using a range of stress testing exercises and scenario analyses.

Risk measures include 1-in-200 year stresses used for regulatory capital assessments and single factor stresses for profit before tax.

Table 1.48 demonstrates the impact of the Group's Eurozone Credit Crunch scenario on Insurance's porfolio (with no diversification benefit, but after the impact of Group consolidation on interest rate and spread widening). This is the most onerous scenario for Insurance out of the Group scenarios. The amounts include movements in assets, liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

Table 1.48: Insurance business: profit before tax sensitivities

	Increase (reduction) in profit before tax	
	2017	2016[1]
	£m	£m
Interest rates – decrease 100 basis points	**(202)**	(387)
Inflation – increase 50 basis points	**24**	(34)
Credit spreads – 100% widening	**140**	369
Equity – 30% fall	**(1,001)**	(681)
Property – 25% fall	**(67)**	(58)

1 Restated. The most onerous scenario has changed to Eurozone Credit Crunch from UK Recession.

Further stresses that show the effect of reasonably possible changes in key assumptions, including the risk-free rate, equity investment volatility, widening of credit default spreads on corporate bonds and an increase in illiquidity premia, as applied to profit before tax are set out in note 32.

Mitigation

Equity and credit spread risks are closely monitored and, where appropriate, asset liability matching is undertaken to mitigate risk. A hedging strategy is in place to reduce exposure from the with-profit funds.

Interest rate risk in the annuity book is mitigated by investing in assets whose cash flows closely match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.

Other market risks (e.g. interest rate exposure outside the annuity book and inflation) are also closely monitored and where considered appropriate, hedges are put in place to reduce exposure.

Monitoring

Market risks in the Insurance business are monitored by Insurance senior executive committees and ultimately the Insurance Board. Monitoring includes the progression of market risk capital against risk appetite limits, as well as the sensitivity of profit before tax to combined market risk stress scenarios and in year market movements. Asset and liability matching positions and hedges in place are actively monitored and if necessary rebalanced to be within agreed tolerances. In addition market risk is controlled via approved investment policies and mandates.

Trading portfolios

Exposures

The Group's trading activity is small relative to its peers and does not engage in any proprietary trading activities. The Group's trading activity is undertaken solely to meet the financial requirements of commercial and retail customers for foreign exchange, credit and interest rate products. These activities support customer flow and market making activities.

All trading activities are performed within the Commercial Banking division. While the trading positions taken are generally small, any extreme moves in the main risk factors and other related risk factors could cause significant losses in the trading book depending on the positions at the time. The average 95 per cent 1-day trading VaR (Value at Risk: diversified across risk factors) was £0.6 million for 31 December 2017 compared to £1.3 million for 31 December 2016. The decrease in exposure was mainly due to high VaR during the first half of 2016 caused by overstatement of the interest rate risk by the VaR model. Improvements to more accurately reflect the risk were implemented in June 2016 which reduced the VaR significantly over the second half of 2016 and over 2017.

Trading market risk measures are applied to all of the Group's regulatory trading books and they include daily VaR (table 1.49), sensitivity based measures, and stress testing calculations.

Measurement

The Group internally uses VaR as the primary risk measure for all trading book positions.

Table 1.49 shows some relevant statistics for the Group's 1-day 95 per cent confidence level VaR that are based on 300 historical consecutive business days to year end 2017 and year end 2016.

The risk of loss measured by the VaR model is the minimum expected loss in earnings given the 95 per cent confidence. The total and average trading VaR numbers reported below have been obtained after the application of the diversification benefits across the five risk types. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported at Group level.

Table 1.49: Trading portfolios: VaR (1-day 95 per cent confidence level) (audited)

	At 31 December 2017				At 31 December 2016			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	0.5	0.6	2.1	0.2	0.7	1.3	7.7	0.5
Foreign exchange risk	0.1	0.1	0.4	0.0	0.1	0.3	0.8	0.1
Equity risk	–	–	–	–	–	–	–	–
Credit spread risk	0.3	0.3	0.5	0.2	0.2	0.2	0.4	0.1
Inflation risk	0.2	0.3	0.9	0.2	0.2	0.3	5.9	0.1
All risk factors before diversification	1.1	1.3	2.9	0.9	1.2	2.1	14.3	1.1
Portfolio diversification	(0.4)	(0.7)			(0.5)	(0.8)		
Total VaR	0.7	0.6	2.2	0.3	0.7	1.3	5.7	0.6

The market risk for the trading book continues to be low with respect to the size of the Group and compared to its peers. This reflects the fact that the Group's trading operations are customer-centric and focused on hedging and recycling client risks.

Although it is an important market standard measure of risk, VaR has limitations. One of them is the use of limited historical data sample which influences the output by the implicit assumption that future market behaviour will not differ greatly from the historically observed period. Another known limitation is the use of defined holding periods which assumes that the risk can be liquidated or hedged within that holding period. Also calculating the VaR at the chosen confidence interval does not give enough information about potential losses which may occur if this level is exceeded. The Group fully recognises these limitations and supplements the use of VaR with a variety of other measurements which reflect the nature of the business activity. These include detailed sensitivity analysis, position reporting and a stress testing programme.

Trading book VaR (1-day 99 per cent) is compared daily against both hypothetical and clean profit and loss. 1-day 99 per cent VaR charts for Lloyds Bank, HBOS and Lloyds Banking Group models can be found in the Group's Pillar 3 Report.

Mitigation

The level of exposure is controlled by establishing and communicating the approved risk limits and controls through policies and procedures that define the responsibility and authority for risk taking. Market risk limits are clearly and consistently communicated to the business. Any new or emerging risks are brought within risk reporting and defined limits.

Monitoring

Trading risk appetite is monitored daily with 1-day 95 per cent VaR and stress testing limits. These limits are complemented with position level action triggers and profit and loss referrals. Risk and position limits are set and managed at both desk and overall trading book levels. They are reviewed at least annually and can be changed as required within the overall Group risk appetite framework.

MODEL RISK

DEFINITION

Model risk is defined as the risk of financial loss, regulatory censure, reputational damage or customer detriment, as a result of deficiencies in the development, application or ongoing operation of models and rating systems.

Models are defined as quantitative methods that process input data into quantitative outputs, or qualitative outputs (including ordinal letter output) which have a quantitative measure associated with them. Model Governance Policy is restricted to specific categories of application of models, principally financial risk, treasury and valuation, with certain exclusions, such as prescribed calculations and project appraisal calculations.

EXPOSURES

There are over 300 models in the Group performing a variety of functions including:

- capital calculation;
- credit decisioning, including fraud;
- pricing models;
- impairment calculation;
- stress testing and forecasting; and
- market risk measurement.

As a result of the wide scope and breadth of coverage, there is exposure to model risk across a number of the Group’s primary risk categories.

MEASUREMENT

The Group risk appetite framework is the key component for measuring the Group's model risk. Reported monthly to the Group Risk Committee and Board, focus is placed on the performance of the Group's most material models.

MITIGATION

The model risk management framework, established by and with continued oversight from an independent team in the Risk division, provides the foundation for managing and mitigating Model Risk within the Group. Accountability is cascaded from the Board and senior management via the Group Risk Management Framework.

This provides the basis for the Group Model Governance Policy, which defines the mandatory requirements for models across the Group, including:

- the scope of models covered by the policy;
- model materiality;
- roles and responsibilities, including ownership, independent oversight and approval; and
- key principles and controls regarding data integrity, development, validation, implementation, ongoing maintenance and validation, monitoring, and the process for non-compliance.

The above ensures models, including those involved in regulatory capital calculation, are developed consistently and are of sufficient quality to support business decisions and meet regulatory requirements.

MONITORING

The Group Model Governance Committee is the primary body for overseeing model risk. Policy requires that Key Performance Indicators are monitored for every model and all issues are escalated appropriately. Material model issues are reported to Group and Board Risk Committees monthly with more detailed papers as necessary to focus on key issues.

INVESTMENT PORTFOLIO, MATURITIES, DEPOSITS, SHORT-TERM BORROWINGS

Trading securities and other financial assets at fair value through profit or loss; available-for-sale financial assets; held-to-maturity investments; and debt securities classified as loans and receivables

The following table sets out the book values and valuation (fair value) of the Group's debt securities, treasury and other bills and equity shares at 31 December for each of the three years indicated.

	2017 Book value £m	**2017 Valuation £m**	2016 Book value £m	2016 Valuation £m	2015 Book value £m	2015 Valuation £m
Trading securities and other financial assets at fair value through profit or loss						
US treasury and US government agencies	1,458	1,458	1,607	1,607	663	663
Other government securities	20,562	20,562	25,125	25,125	21,454	21,454
Other public sector securities	1,527	1,527	1,325	1,325	2,039	2,039
Bank and building society certificates of deposit	222	222	244	244	135	135
Mortgage-backed securities	400	400	707	707	1,358	1,358
Other asset-backed securities	1,021	1,021	1,538	1,538	847	847
Corporate and other debt securities	19,990	19,990	19,832	19,832	20,316	20,316
Treasury bills and other bills	18	18	20	20	74	74
Equity shares	86,090	86,090	67,697	67,697	60,476	60,476
	131,288	131,288	118,095	118,095	107,362	107,362
Available-for-sale financial assets						
US treasury and US government agencies	6,760	6,760	7,564	7,564	6,349	6,349
Other government securities	27,948	27,948	41,150	41,150	18,980	18,980
Bank and building society certificates of deposit	167	167	142	142	186	186
Mortgage-backed securities	1,156	1,156	108	108	197	197
Other asset-backed securities	255	255	317	317	319	319
Corporate and other debt securities	4,615	4,615	6,030	6,030	5,808	5,808
Equity shares	1,197	1,197	1,213	1,213	1,193	1,193
	42,098	42,098	56,524	56,524	33,032	33,032
Held-to-maturity investments						
UK government	–	–	–	–	19,808	19,851
Debt securities classified as loans and receivables						
Mortgage-backed securities	2,366	2,351	2,089	2,065	2,528	2,493
Other asset-backed securities	1,260	1,225	1,290	1,227	1,234	1,173
Corporate and other debt securities	43	10	94	11	526	441
	3,669	3,586	3,473	3,303	4,288	4,107
Allowance for impairment losses	(26)	–	(76)	–	(97)	–

	3,643	3,586	3,397	3,303	4,191	4,107

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MATURITIES AND WEIGHTED AVERAGE YIELDS OF INTEREST-BEARING SECURITIES

The weighted average yield for each range of maturities is calculated by dividing the annualised interest income prevailing at 31 December 2017 by the book value of securities held at that date.

	Maturing within one year		Maturing after one but within five years		Maturing after five but within ten years		Maturing after ten years	
	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %
Trading securities and other financial assets at fair value through profit or loss								
US treasury and US government agencies	2	0.00	222	0.59	226	2.26	1,009	2.48
Other government securities	694	2.60	3,188	2.87	2,732	2.08	13,947	2.60
Other public sector securities	3	5.00	380	2.08	91	4.35	1,053	2.91
Bank and building society certificates of deposit	222	1.50	–	–	–	–	–	–
Mortgage-backed securities	19	0.00	170	1.16	65	5.23	146	3.76
Other asset-backed securities	28	1.61	107	2.33	393	1.01	493	1,80
Corporate and other debt securities	1,424	1.74	3,265	4.72	4,202	3.91	11,099	3.99
Treasury bills and other bills	18	0.94	–	–	–	–	–	–
	2,410		7,332		7,709		27,747	
Available-for-sale financial assets								
US treasury and US government agencies	–	–	4,418	2.62	2,189	5.53	153	2.51
Other government securities	1,051	1.26	10,702	3.73	8,222	3.38	7,973	3.21
Bank and building society certificates of deposit	167	0.13	–	–	–	–	–	–
Mortgage-backed securities	–	–	–	–	–	–	1,156	2.67
Other asset-backed securities	–	–	–	–	53	1.55	202	1.17
Corporate and other debt securities	782	1.42	3,286	1.90	547	2.27	–	–
	2,000		18,406		11,011		9,484	
Debt securities classified as loans and receivables								
Mortgage-backed securities	–	–	2,264	1.4	–	–	102	1.7
Other asset-backed securities	29	0.1	861	0.6	138	1.6	232	1.3
Corporate and other debt securities	17	0.0	–	–	–	–	26	0.5
	46		3,125		138		360	

The Group’s investment holdings at 31 December 2017 include £45,899 million due from the UK government and its agencies and £8,218 million due from the US government and its agencies.

MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AT 31 DECEMBER 2017

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis at 31 December 2017. Following the reduction in the Group’s non-UK activities, an analysis between domestic and foreign operations is not provided.

All amounts are before deduction of impairment allowances. Demand loans are included in the ‘maturing in one year or less’ category.

	Maturing in one year or less £m	Maturing after one but within five years £m	Maturing after five years £m	Total £m
Loans and advances to banks	3,990	2,536	85	6,611
Loans and advances to customers:				
Mortgages	13,906	50,061	240,698	304,665
Other personal lending	5,229	4,759	18,769	28,757
Property companies	4,808	10,921	15,251	30,980
Financial, business and other services	35,044	13,901	8,061	57,006
Transport, distribution and hotels	7,056	4,667	2,351	14,074
Manufacturing	5,086	2,308	492	7,886
Other	9,581	14,300	7,450	31,331
Total loans	84,700	103,453	293,157	481,310
Of which:				
Fixed interest rate	34,279	41,439	139,524	215,242
Variable interest rate	50,421	62,014	153,633	266,068
	84,700	103,453	293,157	481,310

DEPOSITS

The following tables show the details of the Group’s average customer deposits in each of the past three years.

	2017 Average balance £m	2017 Average rate %	2016 Average balance £m	2016 Average rate %	2015 Average balance £m	2015 Average rate %
Non-interest bearing demand deposits	66,276	–	54,379	–	45,294	–
Interest-bearing demand deposits	94,627	0.33	90,272	0.48	83,756	0.47
Savings deposits	168,013	0.23	164,155	0.57	174,239	1.00
Time deposits	86,043	1.15	111,751	1.05	122,142	0.99
Total average deposits	414,959	0.41	420,557	0.60	425,431	0.79

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

CERTIFICATES OF DEPOSIT AND OTHER TIME DEPOSITS

The following table gives details of the Group's certificates of deposit issued and other time deposits at 31 December 2017 individually in excess of US $100,000 (or equivalent in another currency) by time remaining to maturity. Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

	3 months or less £m	Over 3 months but within 6 months £m	Over 6 months but within 12 months £m	Over 12 months £m	Total £m
Certificates of deposit	3,754	3,534	2,658	50	9,996
Time deposits	26,097	6,064	6,578	2,848	41,587
Total	29,851	9,598	9,236	2,898	51,583

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

SHORT-TERM BORROWINGS

Short-term borrowings are included within the balance sheet captions ‘Deposits by banks’, ‘Customer accounts’ and ‘Debt securities in issue’ and are not identified separately on the balance sheet. The short-term borrowings of the Group consist of overdrafts from banks, securities sold under agreements to repurchase, notes issued as part of lending securitisations, certificates of deposit issued, commercial paper and promissory notes issued and other marketable paper. Securities sold under agreements to repurchase, certificates of deposit issued, commercial paper, securitisation notes and covered bonds are the only significant short-term borrowings of the Group.

The following tables give details of these significant short-term borrowings of the Group for each of the past three years.

	2017 £m	2016 £m	2015 £m
Liabilities in respect of securities sold under repurchase agreements			
Balance at the year end	25,813	9,741	7,061
Average balance for the year	18,943	8,342	5,960
Maximum balance during the year	25,813	12,734	9,467
Average interest rate during the year	0.6 %	0.5 %	0.6 %
Interest rate at the year end	1.4 %	0.6 %	0.6 %
Certificates of deposit issued			
Balance at the year end	9,999	8,077	11,101
Average balance for the year	10,284	11,200	11,708
Maximum balance during the year	11,354	13,712	13,925
Average interest rate during the year	0.7 %	0.6 %	0.4 %
Interest rate at the year end	0.7 %	0.7 %	0.2 %
Commercial paper			
Balance at the year end	3,241	3,281	6,663
Average balance for the year	3,653	4,666	5,286
Maximum balance during the year	4,351	7,646	12,700
Average interest rate during the year	1.3 %	0.9 %	0.6 %
Interest rate at the year end	0.0 %	0.0 %	0.0 %
Securitisation notes			
Balance at the year end	3,660	7,253	7,763
Average balance for the year	5,194	7,131	10,362
Maximum balance during the year	7,253	7,436	12,155
Average interest rate during the year	2.5 %	2.5 %	2.4 %
Interest rate at the year end	2.8 %	2.2 %	2.7 %
Covered bonds			
Balance at the year end	26,132	30,521	27,200
Average balance for the year	26,765	30,625	26,503

Maximum balance during the year	30,521	32,444	27,200
Average interest rate during the year	3.2 %	3.5 %	4.2 %
Interest rate at the year end	2.8 %	3.0 %	3.7 %

MANAGEMENT AND EMPLOYEES

DIRECTORS AND SENIOR MANAGEMENT

The Group is led by the Board comprising a Chairman (who was independent on appointment), independent Non-Executive Directors and Executive Directors with a wide range of experience. The appointment of directors is considered by the Nomination and Governance Committee and approved by the Board. Following the provisions in the articles of association, directors must stand for election by the shareholders at the first annual general meeting following their appointment. In line with UK Corporate Governance best practice, all Directors are subject to annual re-election by shareholders at each annual general meeting thereafter. Independent Non-Executive Directors are appointed for an initial term of three years after which their appointment may continue subject to an annual review. Their appointment may be terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation.

The Board meets regularly. In 2017, a total of 10 Board meetings were held, 10 of which were scheduled at the start of the year.

The roles of the Chairman, the Group Chief Executive and the Board and its governance arrangements, including the schedule of matters specifically reserved to the Board for decision, are reviewed annually. The matters reserved to the Board for decision include the approval of the annual report and accounts and any other financial statements; the payment of dividends; the long-term objectives of the Group; the strategies necessary to achieve these objectives; the Group’s budgets and plans; significant capital expenditure items; significant investments and disposals; the basis of allocation of capital within the Group; the organisational structure of the Group; the arrangements for ensuring that the Group manages risks effectively; any significant change in accounting policies or practices; the appointment of the Company’s main professional advisers and their fees (where significant); and the determination of Board and Committee structures, together with their size and composition.

According to the articles of association, the business and affairs of the Company are managed by the Directors, who have delegated to management the power to make decisions on operational matters, including those relating to credit, liquidity and market risk, within an agreed framework.

All Directors have access to the services of the Company Secretary, and independent professional advice is available to the Directors at the Group’s expense, where they judge it necessary to discharge their duties as directors.

The Chairman has a private discussion at least once a year with each Director on a wide range of issues affecting the Group, including any matters which the Directors, individually, wish to raise.

There is an induction programme for all Directors, which is tailored to their specific requirements having regard to their specific role on the Board and their skills and experience to date.

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

NON-EXECUTIVE DIRECTORS

Lord Blackwell Chairman

Age: 65

Chairman of the Nomination and Governance Committee, member of the Remuneration Committee, the Responsible Business Committee and the Board Risk Committee.

Appointed: June 2012 (Board), April 2014 (Chairman)

Skills and experience:

Deep financial services knowledge including in insurance and banking

Significant experience with strategic planning and implementation

Regulatory and public policy experience gained from senior positions in Downing Street, Regulators and a wide range of industries

Credibility with key stakeholders

Strong leadership qualities

Lord Blackwell initially joined the Board as Chairman of Scottish Widows Group. He was previously Senior Independent Director and Chairman of the UK Board for Standard Life and Director of Group Development at NatWest Group. His past Board roles have included Chairman of Interserve plc, and Non-Executive Director of Halma plc, Dixons Group, SEGRO and Ofcom. He was Head of the Prime Minister's Policy Unit from 1995 to 1997 and was appointed a Life Peer in 1997. He has an MA in Natural Sciences from the University of Cambridge, a Ph.D in Finance and Economics and an MBA from the University of Pennsylvania.

External appointments: Governor of the Yehudi Menuhin School and a member of the Governing Body of the Royal Academy of Music.

Anita Frew Deputy Chairman and Senior Independent Director

Age: 60

Chairman of the Remuneration Committee, member of the Audit Committee, the Nomination and Governance Committee, the Responsible Business Committee and the Board Risk Committee.

Appointed: December 2010 (Board), May 2014 (Deputy Chairman), May 2017 (Senior Independent Director)

Skills and experience:

Significant board, financial and general management experience

Experience across a range of sectors, including banking, asset and investment management, manufacturing and utilities

Extensive experience as chairman in a range of industries

Strong board governance experience, including investor relations and remuneration

Anita was previously Chairman of Victrex plc, the Senior Independent Director of Aberdeen Asset Management and IMI plc, an Executive Director of Abbott Mead Vickers, a Non-Executive Director of Northumbrian Water and has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland. She has a BA (Hons) in International Business from the University of Strathclyde, a MRes in Humanities and Philosophy from the University of London, an Honorary DSc for contribution to industry and finance from the University of Cranfield and an Honorary Doctorate in Management and Finance from the University of Aberdeen.

External appointments: Chairman of Croda International Plc and a Non-Executive Director of BHP Billiton.

Alan Dickinson Independent Director

Age: 67

Chairman of the Board Risk Committee, member of the Audit Committee, the Nomination and Governance Committee and the Remuneration Committee.

Appointed: September 2014

Skills and experience:

Highly regarded retail and commercial banker

Strong strategic, risk and core banking experience

Regulatory and public policy experience

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MANAGEMENT AND EMPLOYEES

Alan has 37 years' experience with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK. More recently, Alan was a Non-Executive Director of Willis Limited and Chairman of its Risk Committee. He was formerly Chairman of Brown, Shipley & Co. Limited and a Non-Executive Director of Nationwide Building Society where he was Chairman of its Risk Committee. He is a Fellow of the Chartered Institute of Bankers and the Royal Statistical Society and has an MBA from the Manchester Business School and a BSc from the University of Birmingham.

External appointments: Chairman of Urban&Civic plc and a Governor of Motability.

Simon Henry Independent Director

Age: 56

Chairman of the Audit Committee and a member of the Board Risk Committee.

Appointed: June 2014

Skills and experience:

Deep international experience in board level strategy and execution

Extensive knowledge of financial markets, treasury and risk management

Qualification as an Audit Committee Financial Expert

Strong board governance experience, including investor relations and remuneration

Until recently Simon was Chief Financial Officer and Executive Director of Royal Dutch Shell plc. He was previously Chair of the European Round Table CFO Taskforce and a Member of the Main Committee of the 100 Group of UK FTSE CFOs. He has a BA in Mathematics, an MA from the University of Cambridge and is a fellow of the Chartered Institute of Management Accountants (CIMA).

External appointments: Non-Executive Director of Rio Tinto plc and Rio Tinto Limited, Independent Director of PetroChina Company Limited, Member of the Defence Board and Chair of the Defence Audit Committee, UK

Government, Member of the Advisory Panel of CIMA and of the Advisory Board of the Centre for European Reform.

Lord Lupton CBE Independent Director and Chairman of Lloyds Bank Corporate Markets plc

Age: 62

Member of the Audit Committee and the Board Risk Committee.

Appointed: June 2017

Skills and experience:

Extensive international corporate experience, especially in financial markets

Strong board governance experience, including investor relations and remuneration

Regulatory and public policy experience

Significant experience in strategic planning and implementation

Lord Lupton was Deputy Chairman of Baring Brothers, co-founded the London office of Greenhill & Co., and was Chairman of Greenhill Europe until May 2017. He was previously a Trustee of the British Museum, Governor of Downe House School and a member of the International Advisory Board of Global Leadership Foundation. He became a Life Peer in October 2015 and is a former Treasurer of the Conservative Party. He served on the House of Lords Select Committee on Charities. He read Jurisprudence at Lincoln College, Oxford and is a qualified solicitor.

External appointments: Senior Advisor to Greenhill Europe and Chairman of the Trustees of the Lovington Foundation.

Deborah McWhinney Independent Director

Age: 62

Member of the Audit Committee and the Board Risk Committee.

Appointed: December 2015

Skills and experience:

Extensive executive background in managing technology, operations and new digital innovations across banking, payments and institutional investment

International business and management experience

Experience in consumer analysis, marketing and distribution

Deborah is Chair of the Board Risk Committee's IT Resilience and Cyber Sub-Committee. She is a former Chief Executive Officer, Global Enterprise Payments and President, Personal Banking and Wealth Management at Citibank. Deborah was previously President of Institutional Services at Charles Schwab Corporation and held executive roles at Engage Media Services Group, Visa International and Bank of America, where she held senior roles in Consumer Banking. She holds a BSc in Communications from the University of Montana.

External appointments: Member of the Supervisory Board of Fresenius Medical Care AG & Co. KGaA, Independent Director of Fluor Corporation and IHS Markit Ltd, a Trustee of the California Institute of Technology and of the Institute for Defense Analyses.

Nick Prettejohn Independent Director and Chairman of Scottish Widows Group

Age: 57

Member of the Audit Committee and the Board Risk Committee.

Appointed: June 2014

Skills and experience:

Deep financial services experience, particularly in insurance

In-depth regulatory knowledge and experience

Governance experience and strong leadership qualities

Significant experience in strategic planning and implementation

Nick has served as Chief Executive of Lloyd's of London, Prudential UK and Europe and Chairman of Brit Insurance. He is a former Non-Executive Director of the Prudential Regulation Authority and of Legal & General Group Plc as well as Chairman of the Financial Services Practitioner Panel and the Financial Conduct Authority's Financial Advice Working Group. He was previously a Member of the BBC Trust and Chairman of the Britten-Pears Foundation. Nick has a First Class Degree in Philosophy, Politics and Economics from Balliol College, University of Oxford.

External appointments: Chairman of the Royal Northern College of Music, Non-Executive Director and the Chairman designate of Trinity Mirror plc with effect from 6 March 2018, and a member of the Board of Opera Ventures.

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Stuart Sinclair Independent Director

Age: 64

Member of Remuneration Committee, the Responsible Business Committee and the Board Risk Committee.

Appointed: January 2016

Skills and experience:

Extensive experience in retail banking, insurance and consumer finance

Governance and regulatory experience

Significant experience in strategic planning and implementation

Experience in consumer analysis, marketing and distribution

Stuart is a former Non-Executive Director of TSB Banking Group plc, TSB Bank plc, LV Group, Virgin Direct and Vitality Health (formerly Prudential Health). He was also a Senior Independent Director of Swinton Group Limited. In his executive career, he was President and Chief Operating Officer of Aspen Insurance after spending nine years with General Electric, as Chief Executive Officer of the UK Consumer Finance business then President of GE Capital China. Before that he was Chief Executive Officer of Tesco Personal Finance and Director of UK Retail Banking at the Royal Bank of Scotland. He was a Council member of The Royal Institute for International Affairs (Chatham House). He has an MA in Economics from the University of Aberdeen and an MBA from the University of California.

External appointments: Interim Chairman of Provident Financial Plc with effect from 2 February 2018 (previously Senior Independent Director) and Chair of their Risk Advisory Committee, Senior Independent Director and Chair of Risk at QBE Insurance (Europe) Limited.

Sara Weller CBE Independent Director

Age: 56

Chairman of the Responsible Business Committee, member of the Nomination and Governance Committee, the Remuneration Committee and the Board Risk Committee.

Appointed: February 2012

Skills and experience:

Background in retail and associated sectors, including financial services

Strong board governance experience, including investor relations and remuneration

Passionate advocate of customers, the community, financial inclusion and the development of digital skills

Considerable experience of boards at both executive and non-executive level

Sara's previous appointments include Managing Director of Argos, various senior positions at J Sainsbury including Deputy Managing Director, Chairman of the Planning Inspectorate, Lead Non-Executive Director at the Department of Communities and Local Government, a Non-Executive Director of Mitchells & Butlers as well as a number of senior management roles for Abbey National and Mars Confectionery. She has an MA in Chemistry from Oxford University.

External appointments: Non-Executive Director of United Utilities Group and Chair of their Remuneration Committee and a member of their Nomination Committee, Lead Non-Executive Director at the Department for Work and Pensions, a Governing Council Member of Cambridge University, Board member at the Higher Education Funding Council and Trustee of Lloyds Bank Foundation for England and Wales, with effect from 1 February 2018.

EXECUTIVE DIRECTORS

António Horta-Osório Executive Director and Group Chief Executive

Age: 54

Appointed: January 2011 (Board), March 2011 (Group Chief Executive)

Skills and experience:

Extensive experience in, and understanding of, both retail and commercial banking built over a period of more than 30 years, working both internationally and in the UK

Drive, enthusiasm and commitment to customers

Proven ability to build and lead strong management teams

António previously worked for Citibank, Goldman Sachs and held various senior management positions at Grupo Santander before becoming its Executive Vice President and member of the Group's Management Committee. He was a Non-Executive Director of Santander UK and subsequently its Chief Executive. He is also a former Non-Executive Director of the Court of the Bank of England. António has a Degree in Management & Business Administration from the Universidade Católica Portuguesa, an MBA from INSEAD and has completed the Advanced Management Program at Harvard Business School.

External appointments: Non-Executive Director of EXOR N.V., Fundação Champalimaud and Sociedade Francisco Manuel dos Santos in Portugal, a member of the Board of Stichting INPAR and Chairman of the Wallace Collection.

George Culmer Executive Director and Chief Financial Officer

Age: 55

Appointed: May 2012 (Board)

Skills and experience:

Extensive operational and financial expertise including strategic and financial planning and control

Worked in financial services in the UK and overseas for over 25 years

George was an Executive Director and Chief Financial Officer of RSA Insurance Group, the former Head of Capital Management of Zurich Financial Services and Chief Financial Officer of its UK operations as well as holding various senior management positions at Prudential. He is a Non-Executive Director of Scottish Widows.

George is a Chartered Accountant and has a history degree from the University of Cambridge.

External appointments: None.

Juan Colombás Executive Director and Chief Operating Officer

Age: 55

Appointed: November 2013 (Board), January 2011- September 2017 (Chief Risk Officer), September 2017 (Chief Operating Officer)

Skills and experience:

Significant banking and risk management experience

International business and management experience

Juan was appointed to the role of Chief Operating Officer in September 2017 and is responsible for leading a number of critical Group functions and driving the transformation activities across the Group in order to build the Bank of the Future. Prior to this he served as the Group's Chief Risk Officer and was responsible for developing the Group's risk framework, recommending the Group's risk appetite and ensuring that all risks generated by the business were measured, reviewed and monitored on an ongoing basis. He was previously the Chief Risk Officer and an Executive Director of Santander's UK business. Prior to this, he held a number of senior risk, control and business management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group. Until September 2017 he was the Vice Chairman of the International Financial Risk Institute. Juan has a BSc in Industrial Chemical Engineering from the Universidad Politécnica de Madrid, a Financial Management degree from ICADE School of Business and Economics and an MBA from the Institute de Empresa Business School.

External appointments: None.

EMPLOYEES

As at 31 December 2017, the Group employed 67,905 people (on a full-time equivalent basis), compared with 70,433 at 31 December 2016 and 75,306 at 31 December 2015. At 31 December 2017, 67,172 employees were located in the UK, 367 in continental Europe, 307 in the Americas, and 59 in the rest of the world. At the same date, 31,761 people were employed in Retail, 6,662 in Commercial Banking, 6,095 in Insurance and Wealth, and 23,387 in other functions.

The Group has Codes of Responsibility which apply to all employees. The Codes of Responsibility can be found at: www.lloydsbankinggroup.com/ Responsible-Business.

COMPENSATION

REMUNERATION COMMITTEE

The Committee strongly believes that the Group's remuneration approach, guided by four key reward principles, contributes significantly to the delivery of the Group's strategic priorities.

I am very grateful for the continued support and engagement we have had with shareholders, their representative bodies and our wider stakeholder group. I believe this is reflected in the positive voting outcome we received at the AGM in 2017 for our new remuneration policy. No changes are proposed to that policy.

Simplification

We made changes in 2017 in a drive towards further simplification of remuneration structures, removing complexity, and ensuring a focus on rewarding longer-term, sustainable performance. The Group Performance Share plan was introduced in 2017. The plan outcome is determined on a 'top down' basis, as a percentage of the Group's underlying profit, replacing the previous complex bonus pool methodology driven by aggregated divisional and functional bonus outcomes. There are enhancements to the levels of disclosure within this report, with the aim to provide additional clarity and transparency, particularly relating to the performance assessments that underpin the Group Performance Share outcome both at Group level, and for individual Executive Directors.

From 2018, the Group no longer operates specific incentive arrangements for customer-facing colleagues. Instead, colleagues now participate only in the Group Performance Share plan. Approximately 28,000 customer-facing colleagues have transitioned plans during 2017.

In my last report, I announced that all colleagues in the Group had received an award of Colleague Group Ownership Shares, with the aim of achieving 100 per cent share ownership among colleagues and building a colleague-wide long-term ownership culture. I am pleased to confirm that this award will be repeated in 2018.

Taking into consideration stakeholders' views

The Committee remains acutely aware that the topic of remuneration, alongside corporate culture and working practices, continues to generate a high level of focus and that the role of the Committee is to ensure that the interests of colleagues, shareholders and other key stakeholders are considered fairly, and in the context of wider societal expectations.

I have set a broad agenda for the Committee in 2017, further details of which can be found on page 132. The Committee remit is dynamic and extends beyond executive remuneration, believing that all colleagues should be represented in its consideration. It is our aim to ensure that the remuneration policy framework and guiding principles can be applied consistently to all colleagues. This recognises the importance of colleagues working together, sharing collectively in the Group's success and building a culture of acting as stewards of the long-term interests of the Group.

The Committee remains mindful of the relationship between pay for Executive Directors and all other colleagues. To ensure that the Committee understands wider stakeholder views, I have engaged directly with the Group's recognised unions (Accord and Unite) who represent the interests of around 30,000 colleagues. Feedback from the unions is provided to the Committee

Our key priorities

Simplifying the Group's remuneration policy and principles, with a focus on long-term share ownership

Ensuring remuneration outcomes are fair for all colleagues

Rewarding individual performance and collective success

Providing alignment to the Group's future strategic priorities

Enhancing levels of disclosure and corporate governance

COMPENSATION

Rewarding all colleagues fairly

Group Ownership Share awards	**Direct engagement with unions**	**Our balanced scorecard**	**A single pay budget with higher awards for more junior colleagues**
We aim to achieve 100 per cent share ownership among our colleagues.	Feedback is sought from Accord and Unite on specific matters.	Pay linked to performance on the basis of both 'what' was achieved and 'how' it was delivered.	Increases to base salary for Directors below the Group pay budget.

on specific matters under consultation, for example, in setting the annual pay budget for colleagues and any changes to benefits arrangements. I have also actively engaged with the Group's customers, regulators and my other Board members (including directly with the Responsible Business Committee). In addition, our independent advisers have provided regular updates on market context and emerging topics in remuneration.

Rewarding all colleagues fairly

The Group is committed to offering all colleagues a reward package that is competitive, performance-driven and fair.

In discussions with the Group's recognised unions, a 2018 pay budget of 2.7 per cent was agreed, including additional funding to ensure a minimum pay award of £600 for eligible colleagues. Colleagues in lower pay ranges receive higher awards to support pay progression, together with colleagues who receive stronger performance ratings in recognition of their contribution to the Group. The majority of

Summary of 2017 remuneration outcomes

The 'Remuneration at a glance' section on the following pages provides a summary of the remuneration outcomes for Executive Directors and the key measures against which the Committee determined these outcomes.

I should like to draw attention to the following key messages:

Underlying profit increased to £8,493 million in 2017, exceeding budget by 8.2 per cent. Taking into consideration this financial performance, the Committee agreed an overall Group Performance Share of 5.1 per cent of underlying profit. This was adjusted both positively and negatively to reflect strong performance against stretching Group strategic objectives and conduct provisions impacting negatively on profitability and shareholder returns. In reaching its decision, the Committee considered the impact on customers, conduct and the Group's reputation. The overall outcome determined by the Committee was £414.7 million, approximately 5.5 per cent higher than the equivalent bonus outcome for 2016. The total overall outcome, following the

The Long-Term Incentive Plan (LTIP) awards made in 2015 are vesting at 66.3 per cent, reflecting the Group's strong performance since 2015, balanced against uncertainty in the economic and political environment. In particular, this has impacted negatively on absolute share price performance, resulting in no vesting for the Total Shareholder Return component.

In line with shareholder views, changes to the measures in the 2018 Group Ownership Share awards have been minimised to provide consistency with the 2017 plan, while aligning to the key strategic priorities as set out in the third Group Strategic Review. Further detail is provided on page 130.

colleagues' pay is determined consistently using fixed pay matrices aligned to the external market and designed to help recruit and retain colleagues with the skills, behaviours and motivation to deliver the Group's strategic aims. This approach supports the Group's commitment to the Living Wage Foundation.

The Committee proposes salary increases for the Group Chief Executive and the Chief Financial Officer set below the budget for the wider colleague population, at 2 per cent. Juan Colombás took on a new role of Chief Operating Officer (COO) in September 2017 and accordingly it is proposed he receive a salary increase of 3.4 per cent to reflect the fact that the COO role is larger than his previous role as the Chief Risk Officer.

The Committee considers that pay ratios provide a useful reference point. However, there remains uncertainty and potential confusion how these should be calculated and disclosed. The Committee has therefore chosen not to publish the CEO to colleague pay ratio data alongside this report and will instead comply with the government proposals when these are finalised.

adjustments applied above, is 4.7 per cent of underlying profit before tax which remains significantly lower than the funding limit of 10 per cent. Further detail is provided on page 122, including the detailed metrics in the Group's balanced scorecard.

The approach to determining individual Group Performance Share awards for Executive Directors is consistent with other colleagues. The Committee determined that awards of between 77 per cent and 80 per cent of maximum should be made to the Executive Directors. These awards reflect individual performance assessed on the basis of whole job contribution, both what was achieved and how it was delivered. The average annual Group Performance Share award for colleagues increased by 9.3 per cent relative to 2016, which compares favourably to the average increase in individual awards for Executive Directors of 4 per cent, excluding the Group Chief Executive. The award for the Group Chief Executive increased by 8.4 per cent relative to 2016, reflecting the increase in the base salary against which the award level is determined. The 2017 award is the same percentage of salary as 2016.

COMPENSATION

REMUNERATION AT A GLANCE

HOW WE PERFORMED, AND OUR POLICY

How Executive Directors' remuneration works

Fixed remuneration	l Base salary	**See page 133**	**Variable remuneration**	l Short-term plan	**See page 134**
	l Fixed share award	**See page 133**		l Long-term plan	**See page 134**
	l Pension	**See page 133**			
	l Benefits	**See page 133**			

l **Group Performance Share (GPS) plan**

The Committee determined that the GPS outcome would be **£414.7 million**, based on the following performance outcomes.

1 Excludes MBNA.

2 The underlying profit of £8,493 million has been adjusted by the £74 million incremental difference between the Prudential Value Adjustment (PVA) at year-end 2016 to year-end 2017, in line with regulatory requirements.

3 The underlying profit of £7,867 million has been adjusted (reduced) by the £126 million incremental difference between the PVA at year-end 2015 to year-end 2016.

Group Balanced Scorecard (BSC) performance

BSC category	Rating
Customer	**Strong+**
People	**Strong+**
Control environment	**Strong+**
Building the business	**Strong**
Finance	**Strong**

Collective performance adjustment

The Committee considered the conduct-related provisions, including an additional PPI provision. This led to a downward adjustment of £109.6 million, or 21 per cent.

GPS award versus shareholder returns (% of underlying profit)

The total GPS award as a percentage of underlying profit before tax and GPS allocation decreased from 4.8 per cent in 2016 to 4.7 per cent in 2017. This compares favourably to shareholder return from dividend payments and share buyback over the same period which increased to 36 per cent of underlying profit. The GPS allocation for 2017 remains significantly lower than the Group's funding limit of 10 per cent of underlying profit.

l **Long-term incentive plan**

LTIP awards made in 2015 are vesting at 66.3 per cent, as detailed in the table below. This reflects the Group's strong performance over the three financial years ended 31 December 2017, balanced against uncertainty in the economic and political environment. In particular, this has impacted

negatively on absolute share price performance, resulting in no vesting for the Total Shareholder Return component. Executive Directors are required to retain any vested shares for a further two years after vesting.

Weighting	Measure	Threshold	Maximum	**Actual**	**Vesting**
30%	Absolute total shareholder return (TSR)	8% p.a.	16% p.a.	**(1.7%)**	**0%**
25%	Economic profit	£2,870m	£3,587m	**£3,987m**	**25%**
10%	Cost:income ratio[1]	45.6%	44.5%	**44.9%**	**6.3%**
10%	Customer complaint handling[2]	0.79	0.73	**0.53**	**10%**
	(FCA reportable complaints / FOS uphold rate)	=<32%	=<28%	**15%**	
10%	Net promoter score	3rd	1st	**1st**	**10%**
7.5%	Digital active customer base	12.7m	13.3m	**13.4m**	**7.5%**
7.5%	Colleague engagement score	62	70	**76**	**7.5%**
			LTIP (% maximum) vesting 66.3%		

1 Adjusted total costs.

2 The FCA changed the approach to complaint classification and reporting from 30 June 2016. The Committee determined that the original target should be translated on a like-for-like basis into the new reporting requirement. The Committee was satisfied that the revised targets, set on a mechanical basis, were no less stretching.

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COMPENSATION

Single total figure of remuneration

The charts below summarise the Executive Directors' remuneration for the 2016 and 2017 performance years.

António Horta-Osório Group Chief Executive

£000

George Culmer Chief Financial Officer

£000

Juan Colombás Chief Operating Officer (formerly Chief Risk Officer)[3]

£000

1 2017 Group Performance Share, awarded in March 2018.

2 The LTIP vesting and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 19 February 2018. The average share price between 1 October 2017 and 31 December 2017 (66.75 pence) has been used to indicate the value. The shares were awarded in 2015 based on a share price of 79.93 pence.

3 Juan Colombás took up the role of Chief Operating Officer on 4 September 2017.

2018 policy implementation overview

The detailed policy implementation table containing all elements of remuneration can be found on page 129.

l Base salary	The Group has applied a total pay budget of 2.7 per cent for the wider colleague population. Salary increases for the Group Chief Executive (GCE) and the Chief Financial Officer (CFO) are set below this budget, at 2 per cent. Juan Colombás took on a new role of Chief Operating Officer (COO) in September 2017 and accordingly it is proposed he receive a salary increase of 3.4 per cent to reflect the fact that the COO role is larger than his previous role as the Chief Risk Officer. Salaries will be as follows, effective dates shown below: GCE: £1,244,400 (1 January 2018) CFO: £779,351 (1 April 2018) COO: £779,351 (1 January 2018)
l Fixed share award	The levels of award set for 2018 remain unchanged and are as follows: GCE: £900,000 CFO: £504,000 COO: £497,000
l Group Performance	The maximum Group Performance Share opportunity is 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors (no change).

Share plan	Malus/clawback provisions and holding period apply in line with regulatory requirements.
l Group Ownership Share plan	The maximum annual Group Ownership Share award for Executive Directors is 300 per cent of salary (no change). Awards in 2018, based on individual performance in 2017, are made as follows: GCE: 300 per cent of base salary CFO: 275 per cent of base salary COO: 275 per cent of base salary Malus/clawback provisions and holding period apply in line with regulatory requirements and market practice.

COMPENSATION

ANNUAL REPORT ON REMUNERATION

Single total figure of remuneration (audited)

The following table summarises the total remuneration delivered during 2017 in relation to service as an Executive Director.

	António Horta-Osório		**George Culmer**		**Juan Colombás**		**Totals**	
£000	**2017**	2016	**2017**	2016	**2017**	2016	**2017**	2016
Base salary	**1,220**	1,125	**760**	745	**753**	739	**2,733**	2,609
Fixed share award	**900**	900	**504**	504	**497**	497	**1,901**	1,901
Benefits	**156**	143	**46**	42	**71**	70	**273**	255
Group Performance Share	**1,323**	1,220	**599**	574	**599**	578	**2,521**	2,372
Long-term incentive (LTIP)[1]	**2,257**	1,834	**1,221**	992	**1,204**	883	**4,682**	3,709
Pension allowance	**565**	568	**190**	186	**188**	185	**943**	939
Other remuneration[2]	**1**	1	**1**	1	**1**	1	**3**	3
Total remuneration	**6,422**	5,791	**3,321**	3,044	**3,313**	2,953	**13,056**	11,788

1 The LTIP vesting at 66.3 per cent and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 19 February 2018. The total number of shares vesting were 3,035,880 and 346,087 shares delivered in respect of dividend equivalents for António Horta-Osório, 1,642,361 shares vesting and 187,227 shares delivered in respect of dividend equivalents for George Culmer and 1,619,551 shares vesting and 184,627 shares delivered in respect of dividend equivalents for Juan Colombás. The average share price between 1 October 2017 and 31 December 2017 (66.75 pence) has been used to indicate the value. The shares were awarded in 2015 based on a share price of 79.93 pence. LTIP and dividend equivalent figures for 2016 have been adjusted to reflect the share price on the date of vesting (67.51 pence) instead of the average price (58.30 pence) reported in the 2016 report.

2 Other remuneration payments comprise income from all employee share plans, which arises through employer matching or discounting of employee purchases.

Pension and benefits (audited)

Pension/Benefits £	**António Horta-Osório**	**George Culmer**	**Juan Colombás**
Cash allowance in lieu of pension contribution	**565,000**	**190,081**	**188,364**
Car or car allowance	**12,000**	**15,313**	**12,000**

Flexible benefits payments	**45,000**	**29,964**	**29,547**
Private medical insurance	**35,167**	**760**	**15,985**
Tax preparation	**24,000**	**–**	**10,680**
Transportation	**39,389**	**–**	**2,649**

Defined benefit pension arrangements (audited)

António Horta-Osório has a conditional unfunded pension commitment, subject to share price performance. This was a partial buy-out of a pension forfeited on joining from Santander Group. It is an Employer-Financed Retirement Benefits Scheme (EFRBS). The EFRBS provides benefits on a defined benefit basis at a normal retirement age of 65. The benefit in the EFRBS accrued during the six years following commencement of employment, therefore ceasing to accrue as of 31 December 2016.

The EFRBS was subject to performance conditions. It provides a percentage of the GCE's base salary or reference salary in the 12 months before retirement or leaving. No additional benefit is due in the event of early retirement. The rate of pension accrued in each year depended on share price conditions being met and the total pension due is 6 per cent of the reference salary of £1,220,000 or £73,200.

There are no other Executive Directors with defined benefit pension entitlements.

Under terms agreed when joining the Group, Juan Colombás is entitled to a conditional lump sum benefit of £718,996 either (i) on reaching normal retirement age of 65 unless he voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death.

COMPENSATION

Executive Directors' Group Performance Share outcome for 2017 (audited)

The annual Group Performance Share (GPS) outcome is based on a percentage of the Group's underlying profit, adjusted by a strategic modifier based on the Group's Balanced Scorecard (BSC) metrics and collective and discretionary adjustments to reflect risk matters and other factors.

The Committee determined that the GPS outcome would be £414.7 million, based on the following performance outcomes.

1 Excludes MBNA.

2 The underlying profit of £8,493 million has been adjusted by the £74 million incremental difference between the Prudential Value Adjustment (PVA) at year-end 2016 to year-end 2017, in line with regulatory requirements.

3 The underlying profit of £7,867 million has been adjusted (reduced) by the £126 million incremental difference between the PVA at year-end 2015 to year-end 2016.

The Committee determined that the share of underlying profit should be 5.1 per cent. In reaching this decision, the Committee took into account the Group's actual performance against budget where outperformance was 8.2 per cent and distributions to shareholders which have increased by 46.9 per cent. Due consideration was also given to market levels of variable remuneration on both an individual basis and for the total GPS outcome overall.

Group Balanced Scorecard modifier

A balanced scorecard approach with clearly identified performance descriptors is used to assess Group performance in key areas. Stretching objectives for each division and function were approved by the Committee around the start of the performance year. The objectives are aligned to the Group's strategy and split across five categories: customer, people, control environment, building the business and finance.

The Balanced Scorecard (BSC) is not intended to be a purely mechanical approach to performance assessment, but designed to support the Committee in exercising judgement. It was noted that while there were a diverse range of outcomes, on balance despite challenging economic and external market conditions, the Group had delivered outperformance against 10 of the 20 BSC metrics, with only two falling below the target level; the progress on the creation of the non ring-fenced bank and return on required equity. The Committee discussed a number of key performance factors, noting in particular the Group's outperformance in customer complaints management, colleague engagement despite the significant structural changes during 2017, and strong balance sheet management and capital generation.

The Committee approved the final Group BSC performance outcome at Strong Plus (as detailed in table 'Group Balanced Scorecard performance' on page 123), with the view that while the mechanical BSC assessment was marginal in some areas, on balance there were other qualitative factors that provided the Committee with assurance that the recommendation was fair and justified. Key factors were: the Group's return to full private ownership; significant additional cost reductions; the completion of the successful acquisition of MBNA; and continued focus on commitments to the UK economy through the Helping Britain Prosper strategy.

Under	**Developing**	**Good**	**Strong**	**Strong Plus**	**Top**
0	**0.55**	**1.00**	**1.15**	**1.20**	**1.30**

Collective performance adjustment

Consideration was given to items not factored into the Group underlying profit or the Group BSC. The Committee considered adjustments reflecting 2017 conduct-related provisions, including the additional PPI provision and other non-PPI provisions. In arriving at the adjustment, the Committee considered factors such as customer impact and reputation.

As a result of these items, the Committee approved an overall collective adjustment of £109.6 million (or approximately 21 per cent of the modified GPS outcome) which reduced the total GPS outcome.

COMPENSATION

Group Balanced Scorecard performance

Performance range/outcome2 Objective Measure Under Top **Customer** Creating the best customer experience Customer dashboard The Group has performed below expectations in terms of customer perception of brand, service, products and complaints. The Group has exceeded expectations in terms of customer perception of brand, service, products and complaints. Best customer experience: end-to-end customer journeys The Group has not improved the operation and/or service of its key customer journeys. The Group has significantly improved the operation or service of its key customer journeys. Reportable complaints Total FCA complaints per '000 3.24 > 4.95 ≤ 3.09 Formally closed FCA complaints per '000 0.52 > 0.71 ≤ 0.50 FOS uphold rate (ex PPI) 15% > 30% ≤ 25% **People** Best team: engaged and customer focused colleagues Culture – Best Bank for Customers Index scores 80 ≤ 68 ≥ 84 People colleague engagement – EEI 76 ≤ 57 ≥ 73 People colleague engagement – PEI 83 ≤ 60 ≥ 81 Inclusion & Diversity – F+ Females 34 < 32.4% > 34.3% **Control environment** Maintain a strong control, governance and compliance structure in line with the Risk Management Framework Board risk appetite The Group has not managed its key risk measures to ensure the safe guarding of the Group. The Group has strongly managed its key risk measures to ensure the safe guarding of the Group. Regulatory management The regulatory bodies (FCA and PRA) are concerned about the Group's approach to regulatory matters. The regulatory bodies (FCA and PRA) are comfortable with the Group's approach to regulatory matters and recognise this as an area of strength. **Building the business** Actively manage key stakeholders Simpler and more efficient: Simplification savings The Group has not managed to improve its operational and strategic processes through simplification initiatives and delivered below target savings. The Group has successfully managed to improve its operations and strategic processes through simplification initiatives and delivered above target savings. Best customer experience: Digital active customer growth 13.44m < 13.26m ≥ 13.38m Reputation with external stakeholders – composite (excluding regulators) Poor relationships with key external stakeholders. Strong relationships with key external stakeholders. Deliver Helping Britain Prosper Plan targets (Group) < 50% of Helping Britain Prosper Plan metrics are Green 90%+ of Helping Britain Prosper Plan metrics are Green and none of the Helping Britain Prosper metrics are Red. Establishment of the non ring-fenced bank Key mobilisation milestones are not on track for the separation of the commercial and personal banking customers in line with the regulatory non ring-fenced Bank requirements. Key mobilisation milestones are ahead of schedule and comfortably on track for the separation of the commercial and personal banking customers in line with the regulatory non ring-fenced Bank requirements. Finance Maintain prudent reserves to withstand unexpected shocks Cost:income ratio (Group)1 47.3% Strong > 49.8% < 47.3% Underlying profit before tax (Group)1 8,298m < 7,061m > 8,238m Total return on required equity (Group) 8.1% < 7.0% > 10.5% Underlying Common Equity Tier 1 generation (Group) 245bps < 140bps > 200bps PRA stress test (Group) Failed the annual Prudential Regulation Authority (PRA) stress test due to the Group's capital position and negative feedback on quality of submissions and ranked significantly below peers. Passed the annual Prudential Regulation Authority (PRA) stress test with a strong capital position and very positive feedback on quality of submissions and ranked highly against peers.

1 Excludes MBNA.

2 Where the performance assessment is qualitative the position against threshold and maximum (Under and Top) is shown. Where internal dashboards are used in reaching the assessment of performance, the Committee is provided

with underlying data points and additional commentary to inform its judgement.

COMPENSATION

The individual GPS awards for Executive Directors are determined in the same way as for colleagues across the Group, based on individual performance and the level of GPS outcome determined by the Committee following consideration of the factors set out on pages 122–123. Individual performance is assessed on the basis of 'whole job' contribution, both 'what' has been achieved against BSC objectives, role requirements and personal objectives and 'how' it has been delivered. Judgement is applied in reaching the overall assessment. Awards are approved by the Committee, which has discretion to adjust outcomes for any reason.

In reaching their decision on individual awards for Executive Directors, the Committee considered formulaic payout ranges set around the expected outcome for each performance rating, based on a percentage of base salary (see graphs below for each Executive Director). The percentage of base salary applied within the relevant range was determined by reference to the individual performance rating for each Executive Director.

António Horta-Osório
Group Chief Executive (GCE)

The GCE's individual performance assessment for 2017 reflected the Group's objectives, assessed as Strong Plus as outlined on page 123 and a number of other considerations, including:

Successful delivery of the second Group Strategic Review, with improved customer service, market leading digital proposition, targeted lending growth and simplification savings ahead of target. Completed acquisition of MBNA's prime credit card business.

Next phase of strategy defined to further transform the business for success in a digital world and deliver additional sources of competitive advantage, positioning the Group well to meet changing customer needs.

Restructured the business and reorganised the team ready for the next stage of the Group's strategic journey.

Continued strong underlying financial performance with continued improvement in profit (£8.5 billion, up 8 per cent) and returns (RoTE of 15.6 per cent). Market leading cost:income ratio improving to 46.8 per cent.

Credit and asset quality remain strong. CET1 ratio of 15.5 per cent pre capital return comfortably above requirements. Moody's upgraded Lloyds Bank's credit rating to Aa3 and S&P improved outlook to 'positive'.

Increase in ordinary dividend to 3.05 pence per share (2016: 2.55 pence plus special dividend

0.5 pence per share), in line with the Group's progressive and sustainable dividend policy, with a share buyback of up to £1 billion.

Employee engagement survey results further strengthened, exceeding UK high-performing benchmarks.

Expansion of enhancement to key customer journeys leading to improved customer feedback and trust scores. Total complaints reduced by 18 per cent.

Largest digital bank in the UK, with over 13.4 million digitally active customers, providing best-in-class customer experience (number 1 rated mobile app since 2015).

Significant progress made against Helping Britain Prosper targets with more than £47 billion of lending to first-time buyers since 2014, and 15 per cent increase in lending to SMEs since 2014 (versus market increasing by only 1 per cent). Over 700,000 individuals, businesses and charities trained in digital skills.

Successful return of the Group to full private ownership, repaying the taxpayer £20.3 billion plus an additional £900 million.

BSC category	**Rating**
Customer	**Strong+**
People	**Strong+**
Control environment	**Strong+**
Building the business	**Strong**
Finance	**Strong**

The individual rating of Strong Plus results in a GPS award of £1,322,520 (108 per cent of salary and 77 per cent of maximum).

George Culmer
Chief Financial Officer (CFO)

The CFO's individual performance assessment for 2017 reflected the Finance division's objectives. During 2017, the Group undertook a significant structural change with the responsibility for Legal and Strategy transferring to the CFO from September 2017. The individual performance assessment of the CFO was Strong Plus for full year 2017, informed by the rating for the Finance, Legal and Strategy division at Q4 2017 and a number of other considerations, including:

Strong financial performance delivered in challenging environment with low interest rates and Brexit uncertainty creating downward pressure on the UK economy. Improvements in profit and returns.

Continued improvement in the Group's market leading cost:income ratio to 46.8 per cent (2016: 48.7 per cent). CET1 capital generation of 245 basis points, with CET1 ratio of 15.5 per cent pre capital return, 14.4 per cent pre-buyback, comfortably above requirements.

Continued to build strong relationships with key external stakeholders, including debt and equity investors, regulators, and credit rating agencies.

Effectively managed development of the next phase of the Group's strategy whilst successfully completing delivery of the second Group Strategic Review.

Established the new Finance, Legal and Strategy division effectively, with excellent employee engagement scores and retention of talent.

BSC category	**Rating**
Customer	Strong+
People	Strong
Control environment	Strong+
Building the business	Strong–
Finance	Strong–

The individual rating of Strong Plus results in a GPS award of £599,000 (78 per cent of maximum).

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Juan Colombás
Chief Operating Officer (COO) (formerly Chief Risk Officer)

The COO's individual performance assessment for 2017 reflected the Risk division's objectives and the newly created Chief Operating Office from September 2017. The individual performance assessment of the COO was Strong Plus for full year 2017, informed by the rating for the Risk division at Q3 2017 and a number of other considerations, including:

The Group continues to remain comfortably within the risk appetite set by the Board. Continued to drive a prudent risk culture and control framework to ensure low risk model maintained, positioning the Group well for market developments and uncertainties. Moody's upgraded Lloyds Bank's credit rating to Aa3 and S&P improved outlook to 'positive'.

Further strengthening of operational risk management through enhanced reporting framework. Material reductions in operational losses and events.
Support to the business in development of frameworks and controls to mitigate emerging and evolving risks, such as cyber risks.

Development and maintenance of a high cadre of risk professionals, with employee engagement scores above the high performing norms and strong retention of talent.

Fully supported successful transition to revised Group organisation structure and mobilisation of the new Chief Operating Office function.

Effective implementation of the supporting infrastructure required to drive the transformation activities across the Group to build Bank of the Future.

BSC category	**Rating**
Customer	**Good**
People	**Strong-**
Control environment	**Strong+**
Building the business	**Good+**
Finance	**Top**

The individual rating of Strong Plus results in a GPS award of £599,000 (80 per cent of maximum).

Deferral
The 2017 GPS for all Executive Directors is awarded in a combination of cash and shares. 40 per cent of the GPS will be released in 2018 (£2,000 cash in March, the remainder in shares), 40 per cent will be released in 2019 and the remaining 20 per cent will be released in 2020, subject to remaining in the Group's employment. Any shares released are subject to a further holding period in line with regulatory requirements.

The Group's malus and clawback provisions cover all material risk takers, in line with regulatory requirements. Vested variable remuneration can be recovered from employees for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation. The Committee reserves the right to exercise its discretion in reducing any payment to be made, if it deems appropriate as a result of a risk matter coming to light before vesting.

2015 LTIP vesting (audited)

Awards in the form of conditional rights to free shares in 2015 were made over shares with a value of 300 per cent of reference salary for the GCE and 275 per cent of salary for the CFO and CRO (now COO). These LTIP awards are vesting at 66.3 per cent, as detailed in the table below. This reflects the Group's strong performance over the three financial years ended 31 December 2017, balanced against uncertainty in the economic and political environment. In particular, this has impacted negatively on absolute share price performance, resulting in no vesting for the Total Shareholder Return component. Executive Directors are required to retain any vested shares for a further two years after vesting.

Weighting	Measure	Threshold	Maximum	**Actual**	**Vesting**
30%	Absolute total shareholder return (TSR)	8% p.a.	16% p.a.	**(1.7%)**	**0%**
25%	Economic profit	£2,870m	£3,587m	**£3,987m**	**25%**
10%	Cost:income ratio[1]	45.6%	44.5%	**44.9%**	**6.3%**
10%	Customer complaint handling[2] (FCA reportable complaints/FOS uphold rate)	0.79 =<32%	0.73 =<28%	**0.53** **15%**	**10%**
10%	Net promoter score	3rd	1st	**1st**	**10%**
7.5%	Digital active customer base	12.7m	13.3m	**13.4m**	**7.5%**
7.5%	Colleague engagement score	62	70	**76**	**7.5%**
			LTIP (% maximum) vesting 66.3%		

1 Adjusted total costs.

2 The FCA changed the approach to complaint classification and reporting from 30 June 2016. The Committee determined that the original target should be translated on a like-for-like basis into the new reporting requirement. The Committee was satisfied that the revised targets, set on a mechanical basis, were no less stretching.

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Percentage change in remuneration levels

Figures for 'All employees' are calculated using figures for UK-based colleagues subject to the GPS plan. This population is considered to be the most appropriate group of employees for these purposes because its remuneration structure is consistent with that of the GCE. For 2017, 45,696 colleagues were included in this category.

	% change in base salary (2016 – 2017)	**% change in GPS (2016 – 2017)**	**% change in benefits (2016 – 2017)**
GCE (salary increase effective 1 January 2018)	2	8.4[1]	8.7
All employees	2.7[2]	2[2,3]	2.7[2]

1 Reflects the increase in base salary from 1 January 2017 against which the award is determined.

2 Adjusted for movements in staff numbers and other impacts to ensure a like-for-like comparison. Salary increases effective 1 April 2018.

3 Average awards for colleagues participating in the Group annual GPS increased by 9.3 per cent.

Relative importance of spend on pay (£m)	**Dividend and share buyback[1]** £m	**Salaries and performance-based compensation[2]** £m
The graphs illustrate the total remuneration of all Group employees compared with distributions to shareholders in the form of dividends and share buyback.	1 2017: Ordinary dividend in respect of the financial year ended 31 December 2017, partly paid in 2017 and partly to be paid in 2018 and intended share buyback. 2016: Ordinary and special dividend in respect of the financial year ended 31 December 2016, partly paid in 2016 and partly paid in 2017.	2 In addition to the annual bonus of £414.7 million awarded in respect of 2017 performance, the Group made Group Ownership Share awards of £46.7 million and paid approximately £64.1 million under variable pay arrangements used to incentivise customer-facing colleagues, primarily in the Community Banking and Commercial Banking divisions.

Loss of office payments and payments within the reporting year to past Directors (audited)

There were no payments for the loss of office or any other payments made to former Directors during 2017.

External appointments

António Horta-Osório – During the year ended 31 December 2017, the GCE served as a Non-Executive Director of Exor, Fundação Champalimaud, Stichting INPAR and Sociedade Francisco Manuel dos Santos for which he received fees of £323,688 in total.

Chairman and Non-Executive Directors (audited)

	Fees £000		Total £000	
	2017	2016	**2017**	2016
Chairman and current Non-Executive Directors				
Lord Blackwell[1]	**728**	714	**740**	726
Alan Dickinson	**248**	195	**248**	195
Anita Frew	**364**	295	**364**	295
Simon Henry	**166**	135	**166**	135
Lord Lupton	**161**	–	**161**	–
Deborah McWhinney	**142**	135	**142**	135
Nick Prettejohn	**441**	412	**441**	412
Stuart Sinclair	**152**	135	**152**	135
Sara Weller	**190**	171	**190**	171
Former Non-Executive Directors				
Dyfrig John (retired May 2016)	**–**	49	**–**	49
Anthony Watson (retired May 2017)	**91**	230	**91**	230
Nick Luff (retired May 2017)	**69**	165	**69**	165
Total	**2,752**	2,636	**2,764**	2,648

1 Benefits: car allowance (£12,000).
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Comparison of returns to shareholders and GCE total remuneration

The chart below shows the historical total shareholder return (TSR) of Lloyds Banking Group plc compared with the FTSE 100 as required by the regulations. The FTSE 100 index has been chosen as it is a widely recognised equity index of which Lloyds Banking Group plc has been a constituent throughout this period.

TSR indices – Lloyds Banking Group and FTSE 100

GCE	Dec 2008	Dec 2009	Dec 2010	Dec 2011	Dec 2012	Dec 2013	Dec 2014	Dec 2015	Dec 2016	Dec 2017
GCE single figure of remuneration £000										
J E Daniels		1,121	2,572	855	–	–	–	–	–	–
António Horta-Osório		–	–	1,765	3,398	7,475	11,540	8,704	5,791	6,422
Annual bonus/GPS payout (% of maximum opportunity)										
J E Daniels		Waived	62%	0%	–	–	–	–	–	–
António Horta-Osório		–	–	Waived	62%	71%	54%	57%	77%	77%
Long-term incentive vesting (% of maximum opportunity)										
J E Daniels		0%	0%	0%	–	–	–	–	–	–
António Horta-Osório		–	–	0%	0%	54%	97%	94.18%	55%	66.3%

Notes: J E Daniels served as GCE until 28 February 2011; António Horta-Osório was appointed GCE from 1 March 2011. J E Daniels declined to take a bonus in 2009 and António Horta-Osório declined to take a bonus in 2011.

Directors' share interests and share awards

Directors' interests (audited)

	Number of shares	Number of options	Total shareholding[1]	Value

	Owned outright	Unvested subject to continued employment	Unvested subject to performance	Unvested subject to continued employment	Vested unexercised	Totals at 31 December 2017	Totals at 23 February 2018	Expected value at 31 December 2017 (£000s)[2]
Executive Directors								
António Horta-Osório	**21,611,593**	**3,228,463**	**14,912,901**	**51,277**	**–**	**39,804,234**	**39,804,808[6]**	**22,015**
George Culmer	**12,620,524**	**1,133,621**	**8,238,141**	**29,549**	**–**	**22,021,835**	**22,022,336[6]**	**12,184**
Juan Colombás	**7,937,630**	**1,127,750**	**8,123,722**	**29,109**	**–**	**17,218,211**	**17,218,711[6]**	**8,954**
Non-Executive Directors								
Lord Blackwell	**100,000**	**–**	**–**	**–**	**–**	**100,000**	**n/a[6]**	**n/a**
Alan Dickinson	**200,000**	**–**	**–**	**–**	**–**	**200,000**	**n/a[6]**	**n/a**
Anita Frew	**450,000**	**–**	**–**	**–**	**–**	**450,000**	**n/a[6]**	**n/a**
Simon Henry	**200,000**	**–**	**–**	**–**	**–**	**200,000**	**n/a[6]**	**n/a**
Nick Luff[4]	**400,000**	**–**	**–**	**–**	**–**	**400,000**	**n/a[6]**	**n/a**
Lord Lupton	**550,000**	**–**	**–**	**–**	**–**	**550,000**	**n/a[6]**	**n/a**
Deborah McWhinney[3]	**250,000**	**–**	**–**	**–**	**–**	**250,000**	**n/a[6]**	**n/a**
Nick Prettejohn[5]	**69,280**	**–**	**–**	**–**	**–**	**69,280**	**n/a[6]**	**n/a**
Stuart Sinclair	**–**	**–**	**–**	**–**	**–**	**–**	**n/a[6]**	**n/a**
Anthony Watson[4]	**576,357**	**–**	**–**	**–**	**–**	**576,357**	**n/a[6]**	**n/a**
Sara Weller	**340,000**	**–**	**–**	**–**	**–**	**340,000**	**n/a[6]**	**n/a**

1 Including holdings of connected persons.

2 Awards subject to performance under the LTIP had an expected value of 50 per cent of face value at grant (in line with the Remuneration Policy). Values are based on the 31 December 2017 closing price of 68.06 pence. Full face value of awards are £27,090,761 for António Horta-Osório, £14,988,060 for George Culmer and £11,718,714 for Juan Colombás.

3 Shareholdings held by Deborah McWhinney are either wholly or partially in the form of ADRs.

4 Shares held as at date of resignation/retirement.

5 In addition, Nick Prettejohn held 400 6.475% preference shares at 1 January 2017 and 31 December 2017.

6 The changes in beneficial interests for António Horta-Osório (574 shares), George Culmer (501 shares) and Juan Colombás (500 shares) relate to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2017 and 23 February 2018. There have been no other changes up to 23 February 2018.

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Shareholding requirement (audited)

From 1 January 2017 the shareholding requirement has been focused on base salary only (previously: base salary plus fixed share award) to provide greater transparency in the measurement of the shareholding requirements. This resulted in an increase in the percentage required as a multiple of salary. The new requirements are 350 per cent of base salary for the GCE and 250 per cent of base salary for the other Executive Directors.

In addition to the Group's shareholding requirements, shares vesting are subject to holding periods, in line with regulatory requirements.

António Horta-Osório	Shareholding requirement
	Actual shareholding[1]
George Culmer	Shareholding requirement
	Actual shareholding[1]
Juan Colombás	Shareholding requirement
	Actual shareholding[1]

1 Calculated using the average share price for the period 1 January 2017 to 31 December 2017 (66.85 pence). Includes shares owned outright reduced by forfeitable 'matching' shares under the Share Incentive Plan.

None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

Outstanding share plan interests (audited)

	At 1 January 2017	Granted/ awarded	Dividends awarded	Vested / released / exercised	Lapsed	**At 31 December 2017**	Exercise price	**Exercise periods** From	To	Notes
António Horta-Osório										
LTIP 2014-2016	**4,640,077**	–	164,563	2,552,042	2,088,035	**–**				1, 2, 3
LTIP 2015-2017	**4,579,006**	–	–	–	–	**4,579,006**				3

LTIP 2016-2018	**5,015,210**	–	–	–	–	**5,015,210**				3
GOS 2017-2019		5,318,685	–	–	–	**5,318,685**				3, 4
Deferred GPS awarded in 2017		1,417,778	–	354,443	–	**1,063,335**				5
2014 Sharesave	**14,995**	–	–	–	–	**14,995**	60.02p	01/01/2018	30/06/2018	
2016 Sharesave	**14,554**	–	–	–	–	**14,554**	47.49p	01/01/2020	30/06/2020	
2017 Sharesave		21,728	–	–	–	**21,728**	51.03p	01/01/2021	30/06/2021	6
George Culmer										
LTIP 2014-2016	**2,510,205**	–	89,026	1,380,612	1,129,593	**–**				1, 2, 3
LTIP 2015-2017	**2,477,167**	–	–	–	–	**2,477,167**				3
LTIP 2016-2018	**2,767,409**	–	–	–	–	**2,767,409**				3
GOS 2017-2019		2,993,565	–	–	–	**2,993,565**				3, 4
Deferred GPS awarded in 2017		667,685	–	166,920	–	**500,765**				5
2014 Sharesave	**14,995**	–	–	–	–	**14,995**	60.02p	01/01/2018	30/06/2018	
2016 Sharesave	**14,554**	–	–	–	–	**14,554**	47.49p	01/01/2020	30/06/2020	
Juan Colombás										
LTIP 2014-2016	**2,234,780**	–	79,257	1,229,129	1,005,651	**–**				1, 2, 3
LTIP 2015-2017	**2,442,762**	–	–	–	–	**2,442,762**				3
LTIP 2016-2018	**2,728,973**	–	–	–	–	**2,728,973**				3
GOS 2017-2019		2,951,987	–	–	–	**2,951,987**				3, 4
Deferred GPS awarded in 2017		671,579	–	167,894	–	**503,685**				5
2016 Sharesave	**29,109**	–	–	–	–	**29,109**	47.49p	01/01/2020	30/06/2020	

1 The shares awarded in March 2014 vested on 6 March 2017. The closing market price of the Group's ordinary shares on that date was 67.51 pence. Shares vested are subject to a further two-year holding period.

2 2014 LTIP award was eligible to receive an amount equal in value to any dividends paid during the performance period. Dividend equivalents have been paid based on the number of shares vested and have been paid in shares. The

dividend equivalent shares were paid on 6 March 2017. The closing market price of the Group's ordinary shares on that date was 67.51 pence. The dividend equivalent shares are not subject to any holding period.

3 All LTIPs have performance periods ending 31 December at the end of the three-year period. Awards were made in the form of conditional rights to free shares.

4 Awards (in the form of conditional rights to free shares) in 2017 were made over shares with a value of 300 per cent of reference salary for António Horta-Osório (5,318,685 shares with a face value of £3,660,000); 275 per cent for George Culmer (2,993,565 shares with a face value of £2,059,992); and 275 per cent for Juan Colombás (2,951,987 shares with a face value of £2,031,381). The share price used to calculate face value is the average price over the five days prior to grant (27 February to 3 March 2017), which was 68.814 pence. This was the average share price used to determine the number of shares awarded. Performance conditions for this award are set out in the table below.

5 GPS is deferred into shares. The face value of the share awards in respect of GPS granted in March 2017 was £975,630 (1,417,778 shares) for António Horta-Osório; £459,461 (667,685 shares) for George Culmer; and £462,141 (671,579 shares) for Juan Colombás. The share price used to calculate the face value is the average price over the five days prior to grant (27 February to 3 March 2017), which was 68.814 pence.

6 Sharesave options granted on 29 September 2017.

COMPENSATION

2017 GOS performance measures

Strategic priorities	Measure	Basis of payout range	Metric	Weighting
Creating the best customer experience	FCA total reportable complaints and Financial Ombudsman Service (FOS) uphold rate (excluding PPI)	Set relative to 2019 targets	Threshold: 3.52 complaints per 1,000 accounts Maximum: 3.18 complaints per 1,000 accounts	10%
		Average rate over 2019	Threshold: =<29% Maximum: =<25%	
	Net promoter score	Major Group average ranking over 2019	Threshold: 3rd Maximum: 1st	10%
	Digital active customer base	Set relative to 2019 targets	Threshold: 14.3m Maximum: 14.9m	7.5%
Becoming simpler and more efficient	Economic profit[1]	Set relative to 2019 targets	Threshold: £3,074m Maximum: £3,769m	25%
	Cost:income ratio	Set relative to 2019 targets	Threshold: 47.2% Maximum: 45.7%	10%
Delivering sustainable growth	Absolute total shareholder return (TSR)	Growth in share price including dividends over 3-year period	Threshold: 8% p.a. Maximum: 16% p.a.	30%
Building the best team	Employee engagement index	Set relative to 2019 targets	Threshold: 67 Maximum: 73	7.5%

1 A measure of profit taking into account Expected Losses, tax and a charge for equity utilisation.

None of the other Directors at 31 December 2017 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

Implementation of the policy in 2018

It is proposed to operate the policy in the following way in 2018:

l**Base salary**

The Group has applied a total pay budget of 2.7 per cent including additional funding to ensure a minimum pay award of £600 for eligible colleagues. Salary increases for the Group Chief Executive (GCE) and the Chief Financial Officer (CFO) are set below the budget for the wider colleague population, at 2 per cent. Juan Colombás took on a new role of

Chief Operating Officer (COO) in September 2017 and accordingly it is proposed he receive a salary increase of 3.4 per cent to reflect the fact that the COO role is larger than his previous role as the Chief Risk Officer.

Salaries will therefore be as follows:

GCE: £1,244,400 (1 January 2018)

CFO: £779,351 (1 April 2018)

COO: £779,351 (1 January 2018)

l**Fixed share award**

The levels of the 2018 award are unchanged from 2017:

GCE: £900,000

CFO: £504,000

COO: £497,000

Shares will be released in equal tranches over a five year period.

l**Pension**

The level of pension allowances is unchanged from 2017:

GCE: 50 per cent of base salary less flexible benefits allowance

CFO: 25 per cent of base salary

COO: 25 per cent of base salary

l**Benefits**

For 2018, the benefits provided to Executive Directors include a car allowance, transportation, private medical insurance, life assurance and other benefits selected through the flexible benefits allowance which is currently capped at 4 per cent of base salary (unchanged from 2017).

l**Group Performance Share plan**

The maximum Group Performance Share opportunity will be unchanged from 2017 at 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors. The threshold is set at 20 per cent below the Group's underlying profit target.

For 2018, the Group Performance Share will be based on a percentage of the Group's underlying profit, adjusted by a strategic modifier of up to 130 per cent based on the Group's Balanced Scorecard (BSC) metrics and collective and discretionary adjustments to reflect risk matters and other factors. At least 75 per cent of performance is weighted towards a financial measure.

Individual awards will be adjusted to reflect a balanced scorecard approach with clearly identified performance metrics used to assess Group performance in key areas. Stretching objectives for the Group are approved around the start of the performance year. The objectives are aligned to the Group's strategy and split across five categories: Customer, People, Control environment, Building the business and Finance. Each measure in the Group BSC is assigned targets aligned to a five-point rating scale. BSC ratings are based on a scale ranging from 'Under' (at the lowest level), through 'Developing', 'Good', 'Strong' and up to 'Top'. Each of these ratings may be further differentiated by the addition of 'minus' or 'plus'.

The Committee considers the targets that apply to these measures to be commercially sensitive but will provide information on the level of payout relative to the performance achieved in next year's annual report on remuneration.

The Committee applies its judgement to determine the payout level commensurate with Group, business and/or individual performance.

For the 2018 performance year, the Group Performance Share opportunity will be awarded in March 2019 in a combination of cash (up to 50 per cent) and shares. 40 per cent will be released in the first year following award, 40 per cent will be released in the second year and the remaining 20 per cent will be released in the third year. Any shares released are subject to a further 12-month holding period in line with regulatory requirements.

The Committee may consider the application of malus and clawback as outlined in the performance adjustment section below.

COMPENSATION

l**Group Ownership Share plan**

The maximum Group Ownership Share award for Executive Directors is 300 per cent of salary (unchanged from 2017).

Awards in 2018 are being made as follows:

GCE: 300 per cent of base salary

CFO: 275 per cent of base salary

COO: 275 per cent of base salary

As regulations prohibit the payment of dividend equivalents on awards in 2018 and subsequent years, the number of shares subject to the award has been determined by applying a discount factor to the share price on grant, as previously disclosed. The Committee approved an adjustment of 25 per cent for colleagues who are senior managers, including the Executive Directors.

Awards will be subject to a three-year performance period with vesting between the third and seventh anniversary of award, on a pro-rata basis. Any shares released are subject to a further holding period in line with regulatory requirements and market practice.

Awards made in 2018 will vest based on the Group's performance against the financial and strategic measures, set out in the table below. In line with the Directors' remuneration policy, the Committee has full discretion

to amend payout levels should the award not reflect business and/or individual performance. Business performance includes, but is not limited to, consideration of returns to shareholders.

In line with shareholder views, changes to strategic measures have been minimised to provide consistency with the 2017 plan, while aligning to the key strategic priorities as set out in the third Group Strategic Review. A new measure is proposed for the 2018 plan. The new measure will be Digital Net Promoter Score, to ensure that there is focus on maintaining customer satisfaction and quality of service. To provide alignment to the 2016 and 2017 plans, the Committee will also take into account other factors, for example the number of digitally active customers, when making its overall assessment of performance. Economic profit has been based on statutory profit after tax, not underlying profit, to align more closely with shareholder experience, while maintaining focus on capital efficiency. The targets for this revised measure are considered stretching. For reference, the equivalent outcome in 2017 would be £798 million (including PPI), compared to the 2020 threshold of £2.3 billion. The cost: income ratio measure is inclusive of conduct-related provisions (excluding PPI). The Committee believes that these measures appropriately capture risk management and long-term sustainable growth, aligning management and shareholder interests.

The Committee may consider the application of malus and clawback as outlined in the performance adjustment section below.

Strategic priorities	Measure	Basis of payout range	Metric	Weighting
Creating the best Customer experience	Customer satisfaction	Major Group average ranking over 2020	Threshold: 3rd Maximum: 1st	10%
	Digital net promoter score	Set relative to 2020 targets	Threshold: 64 Maximum: 67	7.5%
	FCA total reportable complaints and Financial Ombudsman Service (FOS) uphold rate	Set relative to 2020 targets Average rates over 2020	Threshold: 2.97 Maximum: 2.69 Threshold: =<29% Maximum: =<25%	10%
Becoming simpler and more efficient	Statutory economic profit	Set relative to 2020 targets	Threshold: £2,300m Maximum: £3,451m	25%
	Cost:income ratio	Set relative to 2020 targets	Threshold: 46.4% Maximum: 43.9%	10%
Delivering sustainable growth	Absolute total shareholder return (TSR)	Growth in share price including dividends over 3-year period	Threshold: 8% p.a. Maximum: 16% p.a.	30%
Building the best team	Employee engagement index	Set relative to 2020 markets norms	Threshold: +5% vs UK Norm Maximum: +2% vs UK High Performing Norm	7.5%

ll **Performance adjustment**

Performance adjustment is determined by the Remuneration Committee and/or Board Risk Committee and may result in a reduction of up to 100 per cent of the GPS and/or GOS opportunity for the relevant period. It can be applied on a collective or individual basis. When considering collective adjustment, the Senior Independent Performance Adjustment and Conduct Committee (SIPACC) submits a report to the Remuneration Committee and Board Risk Committee regarding any adjustments required to BSCs or the overall GPS and/or GOS outcome to reflect in-year or prior year risk matters.

The application of malus will generally be considered when:

– there is reasonable evidence of employee misbehaviour or material error or that they participated in conduct which resulted in losses for the Group or failed to meet appropriate standards of fitness and propriety;

– there is material failure of risk management at a Group, business area, division and/or business unit level;

– the Committee determines that the financial results for a given year do not support the level of variable remuneration awarded; and/or

– any other circumstances where the Committee consider adjustments should be made.

Judgement on individual performance adjustment is informed by taking into account the severity of the issue, the individual's proximity to the issue and the individual's behaviour in relation to the issue. Individual adjustment may be applied through adjustments to BSC assessments and/or through reducing the GPS and/or GOS outcome.

Awards are subject to clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.

The application of clawback will generally be considered when:

– there is reasonable evidence of employee misbehaviour or material error; or

– there is material failure of risk management at a Group, business area, division and/or business unit level.

COMPENSATION

Chairman and Non-Executive Director fees in 2018

The annual fee for the Chairman was increased by 2 per cent to £742,845, in line with the overall salary budget for the executive population.

The annual Non-Executive Director fees were increased by 2 per cent, in line with the base salary increase awarded to the senior management of the Group. These changes took effect from 1 January 2018.

	2018	2017
Basic Non-Executive Director fee	**£78,000**	£76,500
Deputy Chairman	**£102,000**	£100,000
Senior Independent Director	**£61,200**	£60,000
Audit Committee Chairmanship	**£71,400**	£70,000
Remuneration Committee Chairmanship	**£71,400**	£70,000
Board Risk Committee Chairmanship	**£71,400**	£70,000
Responsible Business Committee Chairmanship	**£40,800**	£40,000
Audit Committee membership	**£32,650**	£32,000
Remuneration Committee membership	**£32,650**	£32,000
Board Risk Committee membership	**£32,650**	£32,000
Responsible Business Committee membership[1]	**£15,300**	£15,000
Nomination and Governance Committee membership[2]	**£15,300**	£15,000

1 New members only.
2 Including payments to Chairmen of other Committees who are members.

Non-Executive Directors may receive more than one of the above fees.

Additional disclosures

Total remuneration of the eight highest paid senior executives[1]

The following table sets out the total remuneration of the eight highest paid senior executives (excluding Executive Directors) in respect of the 2017 performance year.

	Executive 8 £000	7 £000	6 £000	5 £000	4 £000	3 £000	2 £000	1 £000
Fixed								
Cash-based	601	498	569	617	635	490	709	815
Share-based	406	100	162	422	422	810	466	500
Total fixed	1,007	598	731	1,039	1,057	1,300	1,175	1,315
Variable								
Upfront cash	2	2	2	2	2	2	2	2
Deferred cash	0	0	0	0	0	0	0	0
Upfront shares	128	604	204	275	200	642	221	202
Deferred shares	195	172	309	416	303	276	335	305
Long-term incentive plan	185	247	401	157	404	524	984	1,113
Total variable pay	510	1,025	916	850	909	1,444	1,542	1,622
Pension cost[2]	160	100	125	154	167	98	177	196
Total remuneration	1,677	1,723	1,772	2,043	2,133	2,842	2,894	3,133

1 Includes members of the Group Executive Committee and Senior Executive level colleagues, employed by the Group as at 31 December 2017 (excluding colleagues on garden leave or subject to notice of termination).
2 Pension costs based on a percentage of salary according to level.

Total remuneration of employees across the Group

Total remuneration[1]	**Number of employees**
£0 to £100,000	68,299
£100,001 to £500,000	4,762
£500,001 to £1,000,000	102
Above £1,000,000	24

1 Total remuneration of UK-based colleagues. Includes base salary, bonus awards for the 2017 performance year, the estimated values of LTIP, pension and benefits.

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COMPENSATION

Remuneration Committee

Committee composition and purpose

The Committee comprises Non-Executive Directors from a wide background to provide a balanced and independent view on remuneration matters. Anthony Watson retired as an independent Non-Executive Director and as a member of the Committee on 11 May 2017. For details of full membership and attendance at meetings, please see page 141.

The purpose of the Committee is to set the remuneration for all Executive Directors and the Chairman, including pension rights and any compensation payments. It recommends and monitors the level and structure of remuneration for senior management and material risk takers. It also considers, agrees and recommends to the Board an overall remuneration policy and philosophy for the Group that is aligned with its long-term business strategy, its business objectives, its risk appetite, values and the long-term interests of the Group that recognises the interests of relevant stakeholders.

Annual effectiveness review

During 2017, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

How the Remuneration Committee spent its time in 2017

The Committee had eight scheduled meetings during 2017 to consider the following principal matters.

Committee:

– Review of committee composition

– Approval of terms of reference

– Results of the effectiveness review and suggestions for improvement

Remuneration approach and awards:

- Determination of 2016 bonus outcome
- Approval of the 2014 LTIP vesting
- Approval of the 2017 Group Performance Share plan design, methodology and performance measures
- Colleague 2017 Group Ownership Share
- Approval of the 2017 and 2018 Group Ownership Shares plan performance measures
- Incentive Plan review

Senior Executives:

- Review of performance and remuneration arrangements for Executive Directors and key senior managers
- Review and approval of material risk taker identification
- Approval of LBCM Non-Executive Fees
- Review of shareholding policy

Stakeholders:

- Feedback from the Chairman on her meeting with the PRA and shareholders
- Consideration of the BEIS Corporate Governance Report and PRA Policy and supervisory statements

Other remuneration matters:

- Approval of the 2016 Directors' Remuneration Report for publication within the annual report and Form 20-F
- Approval of the 2016 Remuneration Policy Statement
- Review of the Reward Governance Framework
- Gender pay reporting review
- Approval of the annual procedural review
- MBNA integration impacts and awards

Mercer (part of the MMC group of companies) is the appointed advisor to the Remuneration Committee. Mercer is a founding member and signatory of the Code of Conduct for Remuneration Consultants.

For more detail, please refer to the website www.remunerationconsultantsgroup.com. Mercer was appointed by the Committee in 2016 following a competitive tender process and was retained during the year. The Committee is of the view that Mercer provides independent remuneration advice to the Committee and does not have any connections with the Group that may impair its independence, and, other than advice on remuneration, no other services were provided to the Company. The broader Mercer company provides unrelated advice on accounting.

During the year, Mercer attended Committee meetings upon invitation and provided advice and support in areas such as market and best practice, regulatory and governance developments, drafting the remuneration report, and relevant comparator groups for pay and performance.

Fees payable for the provision of Remuneration Committee services in 2017 were £98,020, based on time and materials.

António Horta-Osório (Group Chief Executive), Simon Davies (Chief People, Legal and Strategy Officer) until July 2017 and Jen Tippin (Group People and Productivity Director) thereafter, Paul Hucknall (People Director, Centres of Excellence), Matt Sinnott (Group Reward Director), Chris Evans (Director, Reward Policy and Partnering), Stuart Woodward (Head of Reward Regulation and Governance) and Letitia Smith (Group Director, Conduct, Compliance & Operational Risk) provided guidance to the Committee (other than for their own remuneration).

Juan Colombás (Chief Operating Officer from September 2017 and formerly the Chief Risk Officer) and George Culmer (Chief Financial Officer) also attended the Committee to advise as and when necessary on risk, financial and operational matters.

Statement of voting at Annual General Meeting

The table below sets out the voting outcome at the Annual General Meeting in May 2017.

	Votes cast in favour	Votes cast against	Votes withheld

	Number of shares (millions)	**Percentage of votes cast**	**Number of shares (millions)**	**Percentage of votes cast**	**Number of shares (millions)**
Directors' remuneration policy (binding vote)	**47,673**	**98.03%**	**959**	**1.97%**	**535**
2016 annual report on remuneration (advisory vote)	**48,113**	**97.92%**	**1,023**	**2.08%**	**31**

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COMPENSATION

DIRECTORS' REMUNERATION POLICY

The Group's remuneration policy was approved at the AGM on 11 May 2017 and took effect from that date. It is intended that approval of the remuneration policy will be sought at three-year intervals, unless amendments to the policy are required, in which case further shareholder approval will be sought; no changes are proposed for 2018. The full policy is set out in the 2016 annual report and accounts (pages 90–98) which is available at: www.lloydsbankinggroup.com/globalassets/documents/investors/2016/2016_lbg_annual_report_v2.pdf

The tables in this section provide a summary of the Directors' remuneration policy. There is no significant difference between the policy for Executive Directors and that for other colleagues.

Remuneration policy table for Executive Directors

l**Base salary**

Purpose and link to strategy

To support the recruitment and retention of Executive Directors of the calibre required to develop and deliver the Group's strategic priorities. Base salary reflects the role of the individual, taking account of market competitiveness, responsibilities and experience, and pay in the Group as a whole.

Operation

Base salaries are typically reviewed annually with any increases normally taking effect from 1 January. When determining and reviewing base salary levels, the Committee takes into account base salary increases for employees throughout the Group and ensures that decisions are made within the following two parameters:

– An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies.

– Pay for comparable roles in comparable publicly listed financial services groups of a similar size.

Salary may be paid in sterling or other currency and at an exchange rate determined by the Committee.

Maximum potential

The Committee will make no increase which it believes is inconsistent with the two parameters above. Increases will normally be in line with the increase awarded to the overall employee population. However, a greater salary increase may be appropriate in certain circumstances, such as a new appointment made on a salary below a market competitive level, where phased increases are planned, or where there has been an increase in the responsibilities of an individual. Where increases are awarded in excess of the wider employee population, the Committee will provide an explanation in the relevant annual report on remuneration.

Performance measures

N/A

l**Fixed share award**

Purpose and link to strategy

To ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements.

Operation

The fixed share award will initially be delivered entirely in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The Committee can, however, decide to deliver some or all of it in the form of cash.

Maximum potential

The maximum award is 100 per cent of base salary.

Performance measures

N/A

l**Pension**

Purpose and link to strategy

To provide cost effective and market competitive retirement benefits, supporting Executive Directors in building long-term retirement savings.

Operation

Executive Directors are entitled to participate in the Group's defined contribution scheme with company contributions set as a percentage of salary.

An individual may elect to receive some or all of their pension allowance as cash in lieu of pension contribution.

Maximum potential

The maximum allowance for the GCE is 50 per cent of base salary less any flexible benefits allowance.

The maximum allowance for other Executive Directors is 25 per cent of base salary.

All future appointments as Executive Directors will attract a maximum allowance of 25 per cent of base salary.

Performance measures

N/A

l**Benefits**

Purpose and link to strategy

To provide flexible benefits as part of a competitive remuneration package.

Operation

Benefits may include those currently provided and disclosed in the annual report on remuneration.

Core benefits include a company car or car allowance, private medical insurance, life insurance and other benefits that may be selected through the Group's flexible benefits plan.

Additional benefits may be provided to individuals in certain circumstances such as relocation. This may include benefits such as accommodation, relocation, and travel. The Committee retains the right to provide additional benefits depending on individual circumstances.

When determining and reviewing the level of benefits provided, the Committee ensures that decisions are made within the following two parameters:

– An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies.

– Benefits for comparable roles in comparable publicly listed financial services groups of a similar size.

Maximum potential

The Committee will make only increases in the benefits currently provided which it believes are consistent with the two parameters above. Executive Directors receive a flexible benefits allowance, in line with all other employees. The flexible benefits allowance does not currently exceed 4 per cent of base salary.

Performance measures

N/A

COMPENSATION

l**All-employee plans**

Purpose and link to strategy

Executive Directors are eligible to participate in HMRC-approved share plans which promote share ownership by giving employees an opportunity to invest in Group shares.

Operation

Executive Directors may participate in these plans in line with HMRC guidelines currently prevailing (where relevant), on the same basis as other eligible employees.

Maximum potential

Participation levels may be increased up to HMRC limits as amended from time to time. The monthly savings limits for Save As You Earn (SAYE) is currently £500. The maximum value of shares that may be purchased under the Share Incentive Plan (SIP) in any year is currently £1,800 with a two-for-one match. Currently a three-for-two match is operated up to a maximum employee investment of £30 per month.

The maximum value of free shares that may be awarded in any year is £3,600.

Performance measures

N/A

l**Group Performance Share plan**

Purpose and link to strategy

To incentivise and reward the achievement of the Group's annual financial and strategic targets whilst supporting the delivery of long-term superior and sustainable returns.

Operation

Measures and targets are set annually and awards are determined by the Committee after the year end based on performance against the targets set. The Group Performance Share may be delivered partly in cash, shares, notes or other debt instruments including contingent convertible bonds. Where all or part of any award is deferred, the Committee may adjust these deferred awards in the event of any variation of share capital, demerger, special dividend or distribution or amend the terms of the plan in accordance with the plan rules.

Where an award or a deferred award is in shares or other share-linked instrument, the number of shares to be awarded may be calculated using a fair value or based on discount to market value, as appropriate.

The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance. The Committee may reduce the level of award (including to zero), apply additional conditions to the vesting, or delay the vesting of deferred awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of a risk matter coming to light before vesting. Awards may be subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.

Maximum potential

The maximum Group Performance Share opportunities are 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors.

Performance measures

Measures and targets are set annually by the Committee in line with the Group's strategic business plan and further details are set out in the annual report on remuneration for the relevant year.

Measures consist of both financial and non-financial measures and the weighting of these measures will be determined annually by the Committee. The weightings of the performance measures for the 2018 financial year are set out on page 129. All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance (as determined by the Committee) is not met for financial measures or the individual is rated 'Developing performer' or below. The expected value of the Group Performance Share is 30 per cent of maximum opportunity.

The Committee is committed to providing transparency in its decision making in respect of Group Performance Share awards and will disclose historic measures and target information together with information relating to how the Group has performed against those targets in the annual report on remuneration for the relevant year except to the extent that this information is deemed to be commercially sensitive, in which case it will be disclosed once it is deemed not to be sensitive.

l**Group Ownership Share plan**

Purpose and link to strategy

To incentivise and reward Executive Directors and senior management to deliver against strategic objectives designed to support the long-term success of the Group and encourage working as a team. It ensures executives build an ownership interest in the Group and are motivated by delivering long-term superior and sustainable returns for shareholders.

Operation

Awards are granted under the rules of the 2016 Long-Term Incentive Plan approved at the AGM on 12 May 2016. Awards are made in the form of conditional shares or nil cost options. Award levels are set at the time of grant, in compliance with regulatory requirements, and may be subject to a discount in determining total variable remuneration under the rules set by the European Banking Authority.

The number of shares to be awarded may be calculated using a fair value or based on a discount to market value, as appropriate.

Vesting will be subject to the achievement of performance conditions measured over a period of three years, or such longer period, as determined by the Committee.

The Committee retains full discretion to amend the payout levels should the award not reflect business and/or individual performance. The Committee may reduce (including to zero) the level of the award, apply additional conditions to the vesting, or delay the vesting of awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of a risk matter coming to light before vesting. Awards may be subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.

Maximum potential

The maximum annual award for Executive Directors will normally be 300 per cent of salary. Under the plan rules, awards can be made up to 400 per cent of salary in exceptional circumstances.

COMPENSATION

Performance measures

Measures and targets are set by the Committee annually and are set out in the annual report on remuneration each year.

At least 60 per cent of awards are weighted towards typical market (e.g. Total Shareholder Return) and/or financial measures (e.g. economic profit), with the balance on strategic measures.

25 per cent will vest for threshold performance, 50 per cent for on-target performance and 100 per cent for maximum performance.

The measures are chosen to support the best bank for customers strategy and to align management and shareholder interests. Targets are set by the Committee to be stretching within the context of the strategic business plan. Measures are selected to balance profitability, achievement of strategic goals and to ensure the incentive does not encourage inappropriate risk-taking.

Following the end of the relevant performance period, the Committee will disclose in the annual report on remuneration for the relevant year historic measure and target information, together with how the Group has performed against those targets, unless this information is deemed to be commercially sensitive, in which case it will be disclosed once it is deemed not to be sensitive.

ll **Deferral of variable remuneration and holding periods**

Operation

The Group Performance Share and Group Ownership Share plans are both considered variable remuneration for the purpose of regulatory payment and deferral requirements. The payment of variable remuneration and deferral levels are determined at the time of award and in compliance with regulatory requirements (which currently require that at least 60 per cent of total variable remuneration is deferred for seven years with pro rata vesting between the third and seventh year, and at least 50 per cent of total variable remuneration is paid in shares or other equity linked instruments subject to a holding period in line with current regulatory requirements).

A proportion of the aggregate variable remuneration may vest immediately on award. The remaining proportion of the variable remuneration is then deferred in line with regulatory requirements.

Further information on which performance measures were chosen and how performance targets are set are disclosed in the relevant sections throughout the report.

Remuneration policy table for Chairman and Non-Executive Directors

Chairman and Non-Executive Director fees

Purpose and link to strategy

To provide an appropriate reward to attract and retain a high-calibre individual with the relevant skills, knowledge and experience.

Operation

The Committee is responsible for evaluating and making recommendations to the Board with regards to the Chairman's fees. The Chairman does not participate in these discussions.

The GCE and the Chairman are responsible for evaluating and making recommendations to the Board in relation to the fees of the NEDs.

When determining and reviewing fee and benefit levels, the Committee ensures that decisions are made within the following parameters:

- The individual's skills and experience.
- An objective assessment of the individual's responsibilities and the size and scope of their role, using objective sizing methodologies.
- Fees and benefits for comparable roles in comparable publicly listed financial services groups of a similar size.

The Chairman receives an all-inclusive fee, which is reviewed periodically plus benefits including life insurance, car allowance, medical insurance and transportation. The Committee retains the right to provide additional benefits depending on individual circumstances. NEDs are paid a basic fee plus additional fees for the chairmanship/ membership of committees and for membership of Group companies/ boards/non-board level committees.

Additional fees are also paid to the senior independent director and to the deputy chairman to reflect additional responsibilities.

Any increases normally take effect from 1 January of a given year.

The Chairman and the NEDs are not entitled to receive any payment for loss of office (other than in the case of the Chairman's fees for the six month notice period) and are not entitled to participate in the Group's bonus, share plan or pension arrangements.

NEDs are reimbursed for expenses incurred in the course of their duties, such as travel and accommodation expenses, on a grossed-up basis (where applicable).

Maximum potential

The Committee will make no increase in fees or benefits currently provided which it believes is inconsistent with the parameters above.

Performance metrics

N/A

Service agreements

The service contracts of all current Executive Directors are terminable on 12 months' notice from the Group and six months' notice from the individual. The Chairman also has a letter of appointment. His engagement may be terminated on six months' notice by either the Group or him.

Letters of appointment

The Non-Executive Directors all have letters of appointment and are appointed for an initial term of three years after which their appointment may continue subject to an annual review. Non-Executive Directors may have their appointment terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation.

All Directors are subject to annual re-election by shareholders.

The service contracts and letters of appointments are available for inspection at the Company’s registered office.

COMPENSATION

TERMINATION PAYMENTS

It is the Group's policy that where compensation on termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured. Where it is appropriate to make a bonus payment (now known as Group Performance Share) to the individual, this should relate to the period of actual service, rather than the full notice period. Any Group Performance Share payment will be determined on the basis of performance as for all continuing employees and will remain subject to performance adjustment (malus and clawback) and deferral. Generally, on termination of employment, Group Performance Share awards, long-term incentive awards (now known as Group Ownership Share) and other rights to payments will lapse except where termination falls within one of the reasons set out below. In the event of redundancy, the individual may receive a payment in line with statutory entitlements at that time. If an Executive Director is dismissed for gross misconduct, the Executive Director will receive normal contractual entitlements until the date of termination and all deferred Group Performance Share and Group Ownership Share awards will lapse.

	Base salary	Fixed share award	Pension, benefits and other fixed remuneration
Resignation	In the case of resignation to take up new employment, paid until date of termination (including any period of leave required by the Group). In the case of resignation for other reasons, base salary will be paid in monthly instalments for the notice period (or any balance of it), offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Redundancy or termination by mutual agreement	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination unless, in the case of mutual agreement, the Committee determines that exceptional circumstances apply in which case shares may be released on termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Retirement/ill health, injury, permanent disability/death	Paid until date of retirement/death. For ill health, injury or permanent disability which results in the loss of	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be	Paid until date of death/ retirement (subject to individual benefit scheme rules). For ill health,

	employment, paid for the applicable notice period (including any period of leave required by the Group).	reduced to reflect the date of termination except for (i) death where shares are released on the date of termination; or (ii) in the case of permanent disability the Committee determines that exceptional circumstances apply, in which case shares may be released on the date of termination.	injury, permanent disability, paid for the notice period including any period of leave required by the Group (subject to individual benefit scheme rules).
Change of control or merger	N/A	Awards will be payable on the date of the Change of Control and the number of shares subject to the award will be reduced to reflect the shorter accrual period. The Committee may decide that vested awards will be exchanged for (and future awards made over) shares in the acquiring company or other relevant company.	N/A
Other reason where the Committee determines that the executive should be treated as a good leaver	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).

COMPENSATION

	Group Performance Share[(1)]	Long-term incentive/Group Ownership Share[(2)]	Chairman and Non-Executive Director fees[(3)]
Resignation	Unvested deferred Group Performance Share awards are forfeited and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier), unless the Committee determines otherwise in exceptional circumstances.	Awards lapse on date of leaving (or on notice of leaving) unless the Committee determines otherwise in exceptional circumstances that they will vest on the original vesting date (or exceptionally on the date of leaving). Where award is to vest it will be subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Redundancy or termination by mutual agreement	For cases of redundancy, unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Such awards would be subject to deferral, malus and clawback. For termination by mutual agreement, the same approach as for resignation would apply.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Retirement/ill health, injury, permanent disability	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Such awards would be subject to deferral, malus and clawback.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply	Paid until date of leaving Board.
Death	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination. Deferred Group Performance Share awards vest on death in cash, unless the Committee determines otherwise.	Awards vest on death subject to the performance conditions and time pro-rating (for months worked in performance period unless determined otherwise). Malus and clawback will apply.	Paid until date of leaving Board.
Change of control or merger[2]	In-year Group Performance Share accrued up until date of change of control or merger (current year). Where there is a Corporate Event, deferred Group Performance Share awards vest to the extent and timing determined by the Committee in its absolute discretion.	Awards vest on date of event. Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period unless determined otherwise). Malus and clawback will normally apply. Instead of vesting, awards may be exchanged for equivalent awards over	Paid until date of leaving Board.

		the shares of the acquiring company or another company.	
Other reason where the Committee determines that the executive should be treated as a good leaver	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Deferred Group Performance Share awards vest in line with normal timeframes and are subject to malus and clawback. The Committee may allow awards to vest early if it considers it appropriate.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.

1 If any Group Performance Share is to be paid to the Executive Director for the current year, this will be determined on the basis of performance for the period of actual service, rather than the full notice period (and so excluding any period of leave required by the Group).

2 Reference to change of control or merger includes a compromise or arrangement under section 899 of the Companies Act 2006 or equivalent. Fixed share awards may also be released/exchanged in the event of a resolution for the voluntary winding up of the Company; a demerger, delisting, distribution (other than an ordinary dividend) or other transaction, which, in the opinion of the Committee, might affect the current or future value of any award; or a reverse takeover, merger by way of a dual listed company or other significant corporate event, as determined by the Committee. In the event of a demerger, special dividend or other transaction which would in the Committee's opinion affect the value of awards, the Committee may allow a long-term incentive award to vest to the extent relevant performance conditions are met to that date and if the Committee so determined, on a time pro-rated basis (unless determined otherwise) to reflect the number of months of the performance period worked.

3 The Chairman is entitled to six months' notice.

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STATEMENT ON US CORPORATE GOVERNANCE STANDARDS

The Board is committed to the delivery of the Group's new strategy which will transform the Group for success in a digital world. The Board's strategy is underpinned by high standards of corporate governance designed to ensure consistency and rigour in its decision making. This report explains how those standards, in particular, those laid down in the Financial Reporting Council's UK Corporate Governance Code 2016 (the UK Code), apply in practice to ensure that the Board and management work together for the long-term benefit of the Company and its shareholders. The UK Code can be accessed at www.frc.org.uk.

To assist the Board in carrying out its functions and to provide independent oversight of internal control and risk management, certain responsibilities are delegated to the Board's Committees. The Board is kept up to date on the activities of the Committees through reports from each of the Committee Chairmen. Terms of Reference for each of the Committees are available on the website at www.lloydsbankinggroup.com. Information on the membership, role and activities of the Nomination and Governance Committee, the Audit Committee, the Board Risk Committee and the Responsible Business Committee can be found on pages 153 to 163.

Further information about the work of the Remuneration Committee is included on pages 116 to 117 and 131.

As a non-US company listed on the New York Stock Exchange (NYSE) Lloyds Banking Group plc is required to disclose any significant ways in which its corporate governance practices differ from those followed by domestic US companies listed on the NYSE. As Lloyds Banking Group plc's main listing is on the London Stock Exchange, it follows the principles contained in the UK Code. The Group has complied with the provisions of the UK Code and has done so throughout 2017 regarding the provisions where the requirements are of a continuing nature. Key differences are set out below.

The NYSE corporate governance listing standards require domestic US companies to adopt and disclose corporate governance policies. For Lloyds Banking Group plc, consistent with the principles of the UK Code, the Nomination and Governance Committee sets the corporate governance principles applicable to the Company and oversees the annual evaluation of the performance of the Board, its Committees and its individual members.

Under the NYSE corporate governance listing standards, the remuneration, nomination and governance committees of domestic US companies must be comprised of entirely independent directors. However for Lloyds Banking Group plc, again consistent with the principles of the UK Code, the Remuneration Committee and the Nomination and Governance Committee include the Chairman, with all other members being independent non-executive directors.

CORPORATE GOVERNANCE

BUILDING ROBUST STAKEHOLDER RELATIONSHIPS

This report sets out our approach to governance in practice, how the Board works, how it has spent its time during the year, how it has evaluated its performance, and includes reports from each of the Board's Committees.

Good governance is vitally important as it underpins the delivery of our strategy to help Britain prosper and become the best bank for customers, colleagues and shareholders. It is essential to ensure good corporate governance and the associated values are embedded into the thinking and processes of the business, and driven by the Board.

Board changes

The Nomination and Governance Committee is responsible for reviewing the composition of the Board and its Committees and assessing whether the balance of skills, experience, knowledge and independence is appropriate to enable them to operate effectively. It went through a rigorous process leading to the appointment of Lord Lupton as a new independent Non-Executive Director with the additional role of chairing our new non ring-fenced bank. Lord Lupton joined the Board on 1 June 2017, bringing with him extensive international corporate experience (see page 114 for further details). Both Nick Luff and Anthony Watson stepped down from the Board in May 2017, having made significant contributions to the Group. As a result of the two retirements, our Deputy Chairman Anita Frew was appointed as the new Senior Independent Director, and Simon Henry succeeded Nick Luff as the Audit Committee Chairman. The names and biographies of current Directors are set out on pages 113–115. The roles and responsibilities of the Board members are set out on page 151.

The Group's strategic transformation

On 16 May 2017, the Group returned to full private ownership after the government sold its remaining stake. The sale demonstrated the successful delivery of the Group's strategy to transform itself into a simple, low risk, UK focused retail and commercial bank. Since the government first acquired shares in 2009, the Group has repaired its balance sheet, reduced its cost base, cut complexity and international exposure, built and sold TSB, and addressed legacy issues. The Group returned to profitability in 2013 and resumed paying dividends in 2014.

The sale marked the final step in the rescue and rejuvenation of Lloyds Banking Group. The combination of our strong financial performance and the progress we have made towards our strategic priorities has enabled over £21.2 billion to be returned to the government, more than repaying the amount that taxpayers invested.

However, we are not complacent. While we are proud of the progress we have made over the last few years, we recognise we now have an equally challenging task to transform Lloyds Banking Group into a bank that can deliver outstanding service for customers in the future technology environment and play our full role in helping Britain prosper. The Board has spent considerable time over the past two years working with the executive team to understand the requirements to compete successfully as the 'Bank of the Future', and to translate that into the new strategic plan announced with our results. The oversight of this new transformation programme, including the associated cultural changes that will be required, will be a major focus of our ongoing governance activities.

Non ring-fenced bank

One of the largest change initiatives for the Group this year is the implementation of the ring-fencing regulatory requirements which come into effect on 1 January 2019. The Group's approach aims to minimise the impact on both colleagues and customers and for the vast majority there will be no changes. There has been significant progress during the year towards the establishment of the new non ring-fenced bank, Lloyds Bank Corporate Markets plc ('LBCM'). The Board has played an active role in identifying and appointing members of the LBCM board, as well as helping to establish the governance framework to ensure that the framework is both fit for purpose for the new bank and complements that of the Group. An overview by the Chairman of LBCM, Lord Lupton, of the establishment and governance structures of LBCM can be found on page 143.

Board effectiveness

The Board carried out an annual evaluation of its effectiveness during the year. This was an internal evaluation overseen by the Nomination and Governance Committee. The process which was undertaken and the findings of the review are set out on pages 149–150, together with information about our progress against the 2016 review actions.

Diversity

Being able to attract, develop, fully utilise and retain top talent is highly important to us, ensuring everyone has the opportunity to progress and realise their potential. For this reason, the Group has made a commitment to be a leader in diversity, removing the barriers that stand in the way of equal opportunity.

CORPORATE GOVERNANCE

The Board sees it as an important objective for its membership to reflect diversity in its broadest sense. A mix of different backgrounds and experience on the Board, as in the executive team, is important in providing a range of perspectives, insights and challenge needed to support good decision making.

As a Group, we have committed to maintaining at least three female Board members, and recognise the Davies/Hampton-Alexander target for FTSE companies to move towards 33 per cent female representation. We are looking to take opportunities to increase the number of female Board members over time where that is consistent with other skills and diversity requirements. The Group has also made the public commitment to increase the proportion of senior roles held by women to 40 per cent by 2020.

In addition to this, the Group recognises the importance of the diversity of colleagues, reflecting the diversity of our customers, to allow us to better understand customers' needs and create deeper relationships.

The Group's aim is to increase ethnic diversity in our workforce and unlock the potential of our ethnic minority colleagues. The Group has publicly committed to increase the proportion of senior roles held by Black, Asian and Minority Ethnic colleagues to eight per cent by 2020. This is being achieved through career development programmes, a programme of visible role models, and a focus on increasing cultural awareness to help all colleagues interact more effectively, regardless of ethnic background. Our commitment to diversity is led from the top, with Executive Committee sponsorship of the initiatives. More information on both diversity and the importance of succession planning is provided on page 155.

Development of our transformation strategy

In early 2016, following discussions with the Chairman and Board, the Group Chief Executive initiated a major exercise to explore the characteristics required to succeed as the 'Bank of the Future'. Working groups across the Group were engaged in looking forward to the likely impact of changing technology, customer needs and competition, and developing scenarios for different economic backdrops.

The emerging analysis was debated at a two day offsite session involving both the Board and Group Executive Committee in June 2016, and led to the conclusion that a major transformation would be required in evolving our customer propositions, re-engineering our core business processes to incorporate new technology, changing our ways of working and developing new skills and capabilities.

These conclusions were then developed into a programme of change initiatives which were discussed and reviewed in subsequent Board deep dive sessions and, as a whole, in the joint Board and Executive offsite meeting in June 2017.

Having agreed the key initiatives and the overall scale and pace of the transformation, the Board reviewed the more detailed plan and immediate priorities in an extended session in November 2017, placing particular emphasis on the effective management of the programme and the mitigation of potential execution risks. The final proposals were reviewed again in January and confirmed with the 2018 budget in February.

OUR BOARD IN 2017

DIVERSITY, SKILLS AND COMPOSITION

Gender diversity	Skills and experience (Non-Executive Directors only)	Board tenure	Age
	Retail/Commercial Banking		
	Financial markets/wholesale banking/corporate clients		
	Insurance		
A. Male: 9	Prudential and conduct risk in financial institutions	**A.** 0-2 years: 3	**A.** 46-55: 3
B. Female: 3	Core technology operations	**B.** 3-4 years: 4	**B.** 56-65: 8
		C. 5-6 years: 4	**C.** 66-75: 1
	Government/regulatory	**D.** 7-8 years: 1	
	Consumer/marketing/distribution		
	Strategic thinking		

Data as at 31 December 2017.

Board and Committee composition and attendance in 2017

Board member	Board meetings	Nomination and Governance Committee	Audit Committee	Board Risk Committee	Remuneration Committee	Responsible Business Committee
Lord Blackwell (C)	**10/10**	**8/8**	**–**	**8/8**	**7/7**	**5/5**
António Horta-Osório	**10/10**	**–**	**–**	**–**	**–**	**–**
Juan Colombás	**10/10**	**–**	**–**	**–**	**–**	**–**
George Culmer	**10/10**	**–**	**–**	**–**	**–**	**–**
Alan Dickinson	**10/10**	**8/8**	**8/8**	**8/8**	**7/7**	**–**
Anita Frew	**10/10**	**8/8**	**8/8**	**8/8**	**7/7**	**3/5**
Simon Henry	**10/10**	**–**	**8/8** [3]	**8/8**	**–**	**–**
Lord Lupton [1]	**5/5**	**–**	**4/4**	**4/4**	**–**	**–**
Nick Luff [2]	**4/5**	**4/4**	**4/4** [3]	**3/4**	**–**	**–**

Deborah McWhinney	**9/10**	**–**	**8/8**	**8/8**	**–**	**–**
Nick Prettejohn	**8/10**	**–**	**7/8**	**8/8**	**–**	**–**
Stuart Sinclair	**10/10**	**–**	**–**	**8/8**	**7/7**	**4/4** [4]
Anthony Watson [2]	**5/5**	**3/4**	**3/4**	**4/4**	**4/4**	**–**
Sara Weller	**10/10**	**4/4** [5]	**–**	**8/8**	**7/7**	**5/5**

1 Lord Lupton joined the Board and respective Committees on 1 June 2017.

2 Nick Luff and Anthony Watson retired from the Company on 10 May and 11 May respectively.

3 Simon Henry succeeded Nick Luff as Audit Committee Chairman with effect from 1 May 2017.

4 Stuart Sinclair was appointed to the Responsible Business Committee with effect from 1 April 2017.

5 Sara Weller joined the Nomination and Governance Committee on 11 May 2017.

Chairman

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CORPORATE GOVERNANCE

KEY FOCUS AREAS

The Board sets the strategy, oversees its delivery and establishes the culture, values and standards of the Group. The Board ensures that the Group manages risk effectively, monitors financial performance and reporting and ensures that appropriate and effective succession planning arrangements and remuneration policies are in place. It provides and encourages entrepreneurial leadership across the Group within this framework.

Below are details of the main topics discussed by the Board during the year.

Discussions and decisions

Regular updates	Group performance report Finance report, including budgets, forecasts and capital position Risk report Customer performance dashboard Chairman's report Reports from Committee Chairmen
Financial	2017 budget Dividend approval 5 year operating plan Draft results and presentations to analysts Funding and liquidity plans Capital plan Basel Pillar 3 disclosures Annual Report and Form 20-F
Strategy	Two strategy away days to review progress in implementing the Group's strategy 'Deep Dives' on various elements of market development and business strategy (see below) MBNA integration Consideration and approval of large transactions Cloud strategy, which supports the transformation of the Group's IT architecture
Culture and values	Helping Britain Prosper Plan Conduct, culture and values – Culture Dashboard Responsible business report
	Board effectiveness and Chairman's performance reviews

Governance and stakeholders	AGM documentation approval and subsequent voting results briefing Review and approval of the Corporate Governance Framework Review and approval of various Group policies including the Code of Responsibilities, Signing Authorities, Group Statement on Modern Slavery, and Board and GEC Members' Dealing Policy Investor relations updates Committee and meeting simplification review
Regulatory	Ring-fencing progress updates Whistleblowing updates Regulatory updates Senior Manager and Certification Regime FCA strategic review of retail banking business models
Risk management	Approval of Group risk appetite Review of Group non-traded market risk plan Cyber security briefings Review of conduct risk Review and approval of PRA and EBA stress testing results Review and approval of the Risk Management Framework

'Deep dive' sessions

The Board regularly takes the opportunity to hold 'deep dive' sessions with senior management outside formal Board meetings. The purpose of the sessions is to provide the Board with deeper insight into key areas of strategic focus, whilst providing Directors with a greater understanding and appreciation for the subject matter to help drive better quality of debate and enhance knowledge. The sessions are structured to allow plenty of opportunity for discussion and include presentations and videos.

In 2017 'deep dive' sessions were held on the following topics:
- IT architecture strategy
- Customer journeys
- Interest only mortgages
- Consumer credit
- Open banking
- IFRS9 implementation
- Cloud strategy

CORPORATE GOVERNANCE

GOVERNANCE IN ACTION

Overseeing strategy development

The Board held two strategy offsite meetings during the year, giving the Directors the opportunity to focus solely on strategic issues. The first of these was held in June, and concentrated on the priorities of the business and the four strategic pillars which will help the Group progress towards the ‘Bank of the Future’. During the second half of the year, the priorities agreed at the first meeting were developed and the second meeting held in November provided an opportunity to discuss these further, along with financial plans.

António Horta-Osório reflected on the offsite meetings:

The Board offsite meetings are especially important in providing an opportunity to focus on strategic issues, taking a view of the longer-term outlook for the Group.

In June we debated the priorities of the business and the four strategic pillars which will help the Group progress towards the ‘Bank of the Future’. It was extremely helpful to gain the input of our Board members, leveraging the broad range of experience and perspectives the Board has, resulting in a set of clear strategic priorities we will focus on.

In November the Board debated the detailed strategic priorities, associated delivery plans and financial projections. The collective experience and expertise of the Board was brought to life in challenging and scrutinising our plans ensuring we can further transform the Group and deliver sustainable value to our stakeholders over the course of the plan. The Board’s focus on continuing to put the customer at the heart of everything we do, whilst recognising the increasing and critical role of technology, aligned well with the team’s proposals and reinforced our aim to become the best bank for customers, colleagues and shareholders.

Integrating MBNA

In the immediate period following the Group’s announcement of its milestone acquisition of MBNA in December 2016, work commenced to achieve regulatory approval from both the Competition & Markets Authority (CMA) and the Financial Conduct Authority (FCA), and also to prepare for the first day of legal ownership, known as 'Completion'. Unconditional CMA approval was achieved on 5 May 2017 and FCA approval of the Group's Change in Control application was received on 19 May 2017.

In readiness for Completion on 1 June 2017, many activities were completed to support a smooth transition of ownership from Bank of America, such as a review of some 470 IT applications to ensure services could continue, critical policy changes in MBNA to align to the Group and the introduction of a management structure and governance approach which was aligned to the Group's organisational design and risk management framework.

The 'Legal Day 1' Event completed seamlessly on 1 June 2017 with no operational issues. Since then, we have completed a detailed operating model review to identify how best we integrate the MBNA and existing Lloyds Banking Group Cards businesses to ensure we preserve and enhance areas of value creation and opportunities to improve the customer experience for all of our 8 million credit card customers.

The integration programme has moved into the delivery phase and has developed plans with Bank of America to complete the customer, systems and process integration by early 2019.

There is a rigorous governance process to oversee design decision and integration execution, which ensures appropriate and timely updates and escalations up to Board level.

Lloyds Bank Corporate Markets

On 1 June, 2017, I was appointed a Non-Executive Director of Lloyds Banking Group and also as Chairman designate of the newly created 'non ring-fenced bank subsidiary', which is called Lloyds Bank Corporate Markets plc ('LBCM'), subject to regulatory consent. Since then, we have been engaged in a complex, intense and detailed programme to meet all the conditions which the PRA and FCA have set in order to enable them to give us full authorisation to conduct the non ring-fenced activities of the Group, which are required as part of the ring-fencing regulations for UK banks.

Our first, and surely the most important task, was to appoint a Board and senior management team to LBCM. The Board comprises eight Directors, three of whom are independent Non-Executive Directors recruited from outside the Group and all of whom have wide experience of banking, two Directors Designate (Group executives serving in a non-executive capacity and subject to regulatory approval), the Chief Executive, Chief Financial Officer, and myself as Chairman. This composition supports LBCM's legal and regulatory requirements for independent decision making within the overall framework of Group policies and controls. At the same time we have made good progress in appointing the rest of the senior management team of LBCM, such as the Chief Risk Officer, Chief Operating Officer, Chief Internal Auditor and Treasurer from both within and outside the Group. The bank received authorisation from the PRA and FCA in July 2017, subject to conditions. Our current plans are to operationalise the bank, and receive full authorisation for it to commence trading during 2018, leaving us good time to complete the process before the ring-fencing regulations come into force on 1 January 2019.

Since receiving the bank's conditional authorisation in July 2017, the Board has concentrated on creating a bespoke Governance Framework, including the vital Risk Management Framework, which is fit for purpose for LBCM, but also which is consistent and fits within the Group Governance Framework. In essence, LBCM must comply with each and every governance and risk requirement of the Group, but has the right and duty to manage the non ring-fenced bank within any narrower parameters set by the LBCM Board.

CORPORATE GOVERNANCE

Lord Lupton's induction

Induction pack prepared and sent to Lord Lupton prior to and on appointment

This contained key corporate documents, such as:

Role of Director

Group policies such as anti-bribery, expenses, gifts and hospitality, and share dealing

The role of a director and statutory duties, including Companies Act liabilities, Listing Rules, Disclosure Guidance and Transparency Rules and SEC Rules

Directors' and officers' liability insurance

Board and its Committees

Directors', Executive Management and Company Secretary biographies and contact details

Schedule of Board Committee membership

Last Board effectiveness review

Minutes of the last 12 months' Board meetings

Last three Board packs

Financial and strategic

Latest Annual Report

Corporate history, with a summary of significant events

Group management structure chart and business unit details

Key performance indicators, including KPIs on which incentive plans are measured

Risk management

Risk profile, appetite, risk management and internal control procedures

Shareholders

Shareholder analysis/analyst reports

Schedule of Board and Committee meetings and Board calendar

Latest Strategic plan

Guide to ring-fencing

Governance

Corporate Governance Framework

Articles of Association