

Lloyds Banking Group plc  
Form 20-F  
March 10, 2017

**As filed with the Securities and Exchange Commission on 10 March 2017**

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 20-F**

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

OR

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

For the fiscal year ended 31 December 2016

OR

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

OR

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

**Commission file number 001-15246**

**LLOYDS BANKING GROUP plc**

(previously Lloyds TSB Group plc)

(Exact name of Registrant as Specified in Its Charter)

**Scotland**

(Jurisdiction of Incorporation or Organization)

**25 Gresham Street  
London EC2V 7HN**

**United Kingdom**

(Address of Principal Executive Offices)

**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:**

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares	The New York Stock Exchange
\$824,033,000 5.3% Subordinated Securities due 2045	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
\$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
\$1,500,000,000 4.20% Senior Notes due 2017	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:**

Edgar Filing: Lloyds Banking Group plc - Form 20-F

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 2016 was:

Ordinary shares, nominal value 10 pence each	71,373,735,357
Limited voting shares, nominal value 10 pence each	80,921,051
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  No

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

Yes  No

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted

and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer  Non-Accelerated filer

Edgar Filing: Lloyds Banking Group plc - Form 20-F

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

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

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

Item 17  Item 18

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

Yes  No

## TABLE OF CONTENTS

<u>Presentation of information</u>	1
<u>Business overview</u>	2
<u>Selected consolidated financial data</u>	3
<u>Exchange rates</u>	4
<u>Business</u>	4
<u>Operating and financial review and prospects</u>	10
<u>Management and employees</u>	117
<u>Compensation</u>	120
<u>Corporate governance</u>	152
<u>Major shareholders and related party transactions</u>	177
<u>Regulation</u>	178
<u>Listing information</u>	182
<u>Dividends</u>	185
<u>Articles of association of Lloyds Banking Group plc</u>	186
<u>Exchange controls</u>	192
<u>Taxation</u>	193
<u>Where you can find more information</u>	196
<u>Enforceability of civil liabilities</u>	196
<u>Risk factors</u>	197
<u>Forward looking statements</u>	215
<u>Lloyds Banking Group structure</u>	216
<u>Index to the consolidated financial statements</u>	F-1
<u>Glossary</u>	217
<u>Form 20-F cross-reference sheet</u>	219
<u>Exhibit index</u>	221
<u>Signatures</u>	222

## 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 2016, which was \$1.2337 = £1.00. The Noon Buying Rate on 31 December 2016 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 2016, total Lloyds Banking Group assets were £817,793 million and Lloyds Banking Group had 70,433 employees (on a full-time equivalent basis). Lloyds Banking Group plc's market capitalisation at that date was £44,616 million. The Group reported a profit before tax for the 12 months to 31 December 2016 of £3,888 million, and its capital ratios at that date were 21.2 per cent for total capital, 16.8 per cent for tier 1 capital and 13.4 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:

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Net interest income	<b>9,274</b>	11,318	10,660
Other income	<b>30,337</b>	11,832	19,232
<b>Total income</b>	<b>39,611</b>	23,150	29,892
Insurance claims	<b>(22,344)</b>	(5,729 )	(13,493)
<b>Total income, net of insurance claims</b>	<b>17,267</b>	17,421	16,399
Operating expenses	<b>(12,627)</b>	(15,387)	(13,885)
<b>Trading surplus</b>	<b>4,640</b>	2,034	2,514
Impairment	<b>(752 )</b>	(390 )	(752 )
<b>Profit before tax</b>	<b>3,888</b>	1,644	1,762

Lloyds Banking Group's main business activities are retail and commercial banking and long-term savings, protection and investment. 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 2016, the Group's four primary operating divisions, which are also reporting segments, were: Retail; Commercial Banking; Consumer Finance and Insurance. Retail provides banking, mortgages and other financial services to personal and small business customers in the UK. Commercial Banking provides banking and related services to business clients, from SMEs to large corporates. Consumer Finance provides a range of products including personal loans, motor finance, credit cards, and European mortgages and deposit taking. Insurance provides long-term savings, protection and investment products as well as general insurance products in the UK.

Profit before tax is analysed on pages 13 to 16 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 34 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

Edgar Filing: Lloyds Banking Group plc - Form 20-F

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-19 to F-22.

	<b>2016</b>	2015 <sup>1</sup>	2014 <sup>1</sup>
	<b>£m</b>	£m	£m
Retail	<b>3,003</b>	3,091	2,739
Commercial Banking	<b>2,468</b>	2,478	2,256
Consumer Finance	<b>1,283</b>	1,381	1,449
Insurance	<b>837</b>	962	922
Other	<b>276</b>	200	390
<b>Profit before tax – underlying basis</b>	<b>7,867</b>	8,112	7,756

<sup>1</sup> 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.



## 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.

	2016	2015	2014	2013	2012	1
<b>Income statement data for the year ended 31 December (£m)</b>						
Total income, net of insurance claims	17,267	17,421	16,399	18,478	20,517	
Operating expenses	(12,627)	(15,387)	(13,885)	(15,322)	(15,974)	
Trading surplus	4,640	2,034	2,514	3,156	4,543	
Impairment losses	(752)	(390)	(752)	(2,741)	(5,149)	
Profit (loss) before tax	3,888	1,644	1,762	415	(606)	
Profit (loss) for the year	2,164	956	1,499	(802)	(1,387)	
Profit (loss) for the year attributable to ordinary shareholders	1,651	466	1,125	(838)	(1,471)	
Dividends for the year <sup>2,3</sup>	2,175	1,962	535	–	–	
<b>Balance sheet data at 31 December (£m)</b>						
Share capital	7,146	7,146	7,146	7,145	7,042	
Shareholders' equity	42,670	41,234	43,335	38,989	41,896	
Other equity instruments	5,355	5,355	5,355	–	–	
Customer deposits	415,460	418,326	447,067	439,467	426,216	
Subordinated liabilities	19,831	23,312	26,042	32,312	34,092	
Loans and advances to customers	457,958	455,175	482,704	492,952	516,764	
Total assets <sup>1</sup>	817,793	806,688	854,896	842,380	933,064	
<b>Share information</b>						
Basic earnings (loss) per ordinary share	2.4p	0.8p	1.7p	(1.2)p	(2.1)p	
Diluted earnings (loss) per ordinary share	2.4p	0.8p	1.6p	(1.2)p	(2.1)p	
Net asset value per ordinary share	59.8p	57.9p	60.7p	54.6p	59.5p	
Dividends per ordinary share <sup>2,4</sup>	3.05p	2.75p	0.75p	–	–	
Equivalent cents per share <sup>2,4,5</sup>	3.84c	4.03c	1.16c	–	–	
Market price per ordinary share (year end)	62.5p	73.1p	75.8p	78.9p	47.9p	
Number of shareholders (thousands)	2,510	2,563	2,626	2,681	2,733	
Number of ordinary shares in issue (millions) <sup>6</sup>	71,374	71,374	71,374	71,368	70,343	
<b>Financial ratios (%)<sup>7</sup></b>						
Dividend payout ratio <sup>8</sup>	124.9	359.3	45.1	–	–	
Post-tax return on average shareholders' equity	4.1	1.3	2.9	(2.0)	(3.3)	
Post-tax return on average assets	0.26	0.11	0.17	(0.09)	(0.14)	
Average shareholders' equity to average assets	5.2	5.1	4.7	4.7	4.6	
Cost:income ratio <sup>9</sup>	73.1	88.3	84.7	82.9	77.9	
<b>Capital ratios (%)<sup>10,11,12</sup></b>						
Total capital	21.2	21.5	22.0	20.8	17.3	
Tier 1 capital	16.8	16.4	16.5	14.5	13.8	
Common equity tier 1 capital/Core tier 1 capital	13.4	12.8	12.8	14.0	12.0	

1 Restated, where appropriate, in 2013 for IAS 19 (Revised) and IFRS 10.

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

3 Dividends for the year in 2016 include a recommended special dividend totalling £356 million; dividends for the  
year in 2015 included a special dividend totalling £357 million.

4 Dividends per ordinary share in 2016 include a recommended special dividend of 0.5 pence; dividends per ordinary  
share in 2015 included a special dividend of 0.5 pence.

Translated into US dollars at the Noon Buying Rate on the date each payment was made, with the exception of the  
5 final and special dividends in respect of 2016, which have been translated at the Noon Buying Rate on 24 February  
2017.

6 This figure excludes the limited voting ordinary shares owned by the Lloyds Bank Foundations.

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

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

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

10 Capital ratios for 2012 were not restated to reflect the adoption of IAS 19 (Revised) in 2013.

11 Capital ratios for 2013 and earlier years are in accordance with the modified Basel II framework as implemented by  
the PRA.

12 Capital ratios for 2014, 2015 and 2016 are in accordance with the CRD IV rules implemented by the PRA on 1  
January 2014.

3

## 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:

	<b>2017</b>	<b>2016</b>	<b>2016</b>	<b>2016</b>	<b>2016</b>	<b>2016</b>
	<b>January</b>	<b>December</b>	<b>November</b>	<b>October</b>	<b>September</b>	<b>August</b>
US dollars per pound sterling:						
High	<b>1.26</b>	<b>1.27</b>	<b>1.25</b>	<b>1.28</b>	<b>1.34</b>	1.33
Low	<b>1.21</b>	<b>1.22</b>	<b>1.22</b>	<b>1.22</b>	<b>1.30</b>	1.29

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:

	2016	2015	2014	2013	2012
US dollars per pound sterling:					
Average	1.34	1.53	1.65	1.57	1.59

On 24 February 2017, the latest practicable date, the US dollar Noon Buying Rate was \$1.2499 = £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; through sales of shares in September 2013 and March 2014 and the impact of a trading plan with Morgan Stanley & Co. International plc (Morgan Stanley), this had reduced to 9.9 per cent by 31 December 2015.

UKFI announced on 7 October 2016 that it intended to continue to sell Her Majesty's Treasury's (HMT) shareholding in Lloyds Banking Group plc over the next 12 months through a pre-arranged trading plan managed by Morgan Stanley. Under the trading plan, Morgan Stanley has full discretion to effect a measured and orderly sell down of shares in Lloyds Banking Group plc on behalf of HMT. The trading plan commenced on 7 October and will terminate no later than 6 October 2017. HMT has instructed Morgan Stanley that (a) up to, but no more than, 15 per cent of the aggregate total trading volume in Lloyds Banking Group plc may be sold over the duration of the trading plan, and (b) shares may not be sold under the trading plan below a certain price per share that UKFI and HMT have determined represents fair value currently and continues to deliver value for money for the UK taxpayer. As at 22 February 2017, HMT owned approximately 2.8 billion ordinary shares in Lloyds Banking Group plc, which represents less than 4 per cent of the issued ordinary share capital.

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 retained an interest of approximately 50 per cent in TSB as at 31 December 2014. The Group sold its remaining interest in TSB to Banco de Sabadell (Sabadell) in 2015, with the acquisition becoming unconditional in all respects on 30 June 2015 following the receipt of all relevant regulatory clearances.

4

## 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.

The Group operates a simple, low-risk, customer focused retail and commercial banking business primarily in the UK. The Group's corporate strategy is built around being the best bank for individual and business customers across the UK and creating value by investing in areas that make a real difference to these customers.

Following the successful delivery of the Group's 2011 strategy that underpinned the Group's low cost, low risk, customer focused, UK retail and commercial banking business model, the Group outlined the next phase of its strategy in October 2014. The Group's strategy is focused upon delivering value and high quality experiences for customers alongside superior and sustainable financial performance within a prudent risk and conduct framework. This will be achieved through three strategic priorities which will be consistently applied across all divisions:

### **CREATING THE BEST CUSTOMER EXPERIENCE**

The Group's ambition is to create the best customer experience through its multi brand, multi channel approach, combining comprehensive online and mobile capabilities with face to face services. This involves transforming the Group's digital presence while sustaining extensive customer reach through a branch network focused on delivering high quality service and the right outcomes for customers.

### **BECOMING SIMPLER AND MORE EFFICIENT**

The Group is focused on creating operational capability which is simpler and more efficient and will become more responsive to changing customer expectations while maintaining its cost leadership amongst UK high street banks. This includes a second phase of the Simplification programme to achieve run-rate savings of £1.4 billion per annum by the end of 2017. In order to achieve these savings, the Group will invest around £2.2 billion over three years on initiatives to simplify processes and increase automation.

## **DELIVERING SUSTAINABLE GROWTH**

The Group will seek Group-wide growth opportunities whilst maintaining its prudent risk appetite. This will be achieved by maintaining market leadership in its retail business lines while also focusing on areas where the Group is currently under represented.

## **SUMMARY**

The Group's purpose is to help Britain prosper. The Group is creating a simpler, more agile, efficient and responsive customer focused organisation which operates sustainably and responsibly. The achievement of our strategy could not happen without the support of our colleagues. We are therefore committed to 'building the best team' to create a high performance organisation. The Group believes that the successful execution of its strategy will enable delivery of superior and sustainable returns for shareholders.

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

At 31 December 2016 the Group's activities were organised into four financial reporting segments: Retail; Commercial Banking; Consumer Finance and Insurance.

Further information on the Group's segments is set out on pages 28 to 34 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.

## BUSINESS

## ENVIRONMENTAL MATTERS

## MANAGING AND REDUCING OUR ENVIRONMENTAL IMPACTS

The Group's ability to help Britain prosper is inextricably linked to wider environmental issues. Man-made climate change and global trends, such as resource scarcity, extreme weather and rising energy and commodity prices, have an impact on the Group's its own operations and stakeholders. The Group is committed to managing its direct environmental impact and reducing its greenhouse gas emissions. The Group manages its impacts through its Environmental Action Plan, which focuses on reducing risk and creating value through improved efficiency.

**Emissions**

This year the Group's overall carbon emissions, measured in CO<sub>2</sub>e equivalent tonnes (CO<sub>2</sub>e), have decreased by 12.95 per cent year-on-year and by 38.83 per cent against the Group's 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) and the Group's energy optimisation programme.

CO<sub>2</sub>e emissions

	Oct 2015 – Sept 2016	Oct 2014 – Sept 2015 <sup>1</sup>	Oct 2013 – Sept 2014 <sup>1</sup>
Total CO <sub>2</sub> e tonnes	<b>344,316</b>	395,554	437,721
Total scope 1	<b>52,438</b>	57,255	59,856
Total scope 2	<b>205,127</b>	239,721	261,623
Total scope 3	<b>86,752</b>	98,579	116,242

<sup>1</sup> Restated 2013/2014 and 2014/2015 emissions data to improve the accuracy of reporting, using actual data to replace estimations.

Emissions in tonnes CO<sub>2</sub>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/ResponsibleBusiness](http://www.lloydsbankinggroup.com/ResponsibleBusiness).

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 2016 Annual Responsible Business Reporting. Deloitte's 2016 assurance statement and the 2016 Reporting Criteria are available online at [www.lloydsbankinggroup.com/RBdownloads](http://www.lloydsbankinggroup.com/RBdownloads).

### **Supporting the low carbon economy**

The Group continues to develop products and services to support customers' transition to a lower carbon, more resource efficient economy. Since 2014 the Group has launched two Environmental, Social and Governance (ESG) bonds totalling £500 million. Lloyds Bank became the first UK bank to develop an ESG deposit scheme in response to client demand to invest in products that create positive ESG impacts.

In March 2016 Lloyds Bank launched its innovative £1 billion Green Loan Initiative for commercial real estate lending. The initiative – the first of its kind in the UK – provides clients with loans at discounted margins to help incentivise energy efficiency and finance investment in green buildings. The Group completed the first tranche of deals in the second half of 2016, totalling £72 million, and has helped borrowers like HPH, a Bath-based property company with a diverse property portfolio, to fund energy efficiency projects. The Group has now set a target in its Helping Britain Prosper Plan to fund 10 million square feet of commercial real estate to become more energy efficient by 2020, the equivalent of seven London Shards.

In 2016 the Group's UK-based team was responsible for financing renewable projects with a combined capacity of more than 1.78GW. Globally, the Group's investments in renewable energy are in excess of 7.4GW in capacity and cover solar, offshore and onshore wind, waste to energy and biomass.

In 2016 Lloyds Bank played a key part in financing a major offshore wind farm off the Norfolk coast, with operations in Grimsby. Race Bank will provide enough energy to power 400,000 homes with a potential capacity of 573MW. It is anticipated the project, when in operation, will create more than 100 jobs associated with building and maintaining turbines for the Humber region.

## **PROPERTIES**

At 31 December 2016, Lloyds Banking Group occupied 2,221 properties in the UK. Of these, 543 were held as freeholds and 1,678 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 155 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**

The Group increased the provision for PPI costs by a further £1,350 million in 2016, bringing the total amount provided to £17,375 million.

The charge to the provision in 2016 was largely driven by a higher total volume of complaints expected as a result of the Financial Conduct Authority's (FCA) industry deadline being extended to the end of August 2019 as well as changes to the rules and guidance that should apply when firms handle PPI complaints in light of the UK Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 (*Plevin*). Final rules and guidance were published by the FCA on 2 March 2017 (PS 17/3).

**BUSINESS**

As at 31 December 2016, a provision of £2,608 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £2,200 million during the year to 31 December 2016. Spend continues to reduce following the completion of the re-review of previously handled cases (remediation).

The provision is consistent with total expected reactive complaint volumes of 5.2 million (including complaints falling under the Plevin rules and guidance) in light of the FCA Policy Statement PS 17/3. Weekly complaint levels in the second half of 2016 have been approximately 8,300 versus approximately 8,600 in the first half, and are expected to vary significantly through to the industry deadline, now confirmed to be August 2019.

**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 50 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 Companies and customer activity.

Key metrics and sensitivities are highlighted in the table below:

	Actuals	Anticipated	
Sensitivities (exclude claims where no PPI policy was held)	to date	future <sup>3</sup>	Sensitivity <sup>3</sup>
Customer initiated complaints since origination (m) <sup>1</sup>	3.9	1.3	0.1 = £190m
Average uphold rate per policy <sup>2</sup>	74%	89%	1% = £35m
Average redress per upheld policy <sup>2</sup>	£1,700	£1,250	£100 = £150m
Administrative expenses (£m)	3,190	490	1 case = £375

<sup>1</sup> Sensitivity includes complaint handling costs.

<sup>2</sup> Actuals to date are based on the last six months to 31 December 2016.

Anticipated future and sensitivities are impacted by a proportion of complaints and re-complaints falling under the *Plevin* rules and guidance in light of the FCA Policy Statement PS 17/3.

## **PACKAGED BANK ACCOUNTS**

In the year ended 31 December 2016 the Group has provided an additional £280 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £505 million. As at 31 December 2016, £215 million of the provision remained unutilised. The total amount provided 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.

## **ARREARS HANDLING RELATED ACTIVITIES**

Following a review of the Group's secured and unsecured arrears handling activities, the Group has put in place a number of actions to further improve its handling of customers in these areas. As a result, the Group has provided an additional £261 million in the year ended 31 December 2016 (bringing the total provision to £397 million), for the costs of identifying and rectifying certain arrears management fees and activities. As at 31 December 2016, the unutilised provision was £383 million (31 December 2015: £136 million).

## **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 has continued to lead to an increasing number of claims in 2016. Accordingly a provision increase of £94 million was recognised in the year ended 31 December 2016 giving a total provision of £639 million; the remaining unutilised provision as at 31 December 2016 is £168 million (31 December 2015: £124 million). 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.

## **PROVISIONS FOR OTHER 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 and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In the year ended 31 December 2016, the Group

charged an additional £450 million in respect of matters across all divisions. At 31 December 2016, the Group held unutilised provisions totalling £573 million for these other legal actions and regulatory matters.

## **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 certain competition investigations into MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA;

Litigation continues in the English Courts against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs. From publicly available information, it is understood these damages claims are running to different timescales with respect to the litigation process. It is also possible that new claims may be issued.

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

## BUSINESS

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. The Group's share of the sale proceeds comprised cash consideration of approximately £330 million (of which approximately £300 million was received on completion of the sale and £30 million is deferred for three years) and preferred stock, which the Group measures at fair value. The preferred stock is convertible into Class A Common Stock of Visa Inc or its equivalent upon the occurrence of certain events. 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, currently 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. The lawsuits, which contain broadly similar allegations, allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act and the Commodity Exchange Act, as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims, including those asserted under US anti-trust laws, were dismissed by the US Federal Court for Southern District of New York (the District Court). In November 2015 OTC and exchange-based plaintiffs' claims against the Group were dismissed for lack of personal jurisdiction. On 20 December 2016, the Federal Court for Southern District of New York dismissed all antitrust class action claims against LBG and its affiliates in the Multi District Litigation arising from the alleged manipulation of USD LIBOR. Further appeals in relation to the anti-trust claims remain possible.

Certain Group companies are also named as defendants in UK based claims raising LIBOR manipulation allegations in connection with interest rate hedging products.

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 filed in the English High Court 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. It is currently not possible to determine the ultimate impact on the Group (if any), but the Group intends to defend the claim vigorously.

## **FINANCIAL SERVICES COMPENSATION SCHEME**

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

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. At 31 March 2016, the end of the latest FSCS scheme year for which it has published accounts, the principal balance outstanding on these loans was £15,655 million (31 March 2015: £15,797 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 of the FSCS. The amount of future levies payable by the Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

## **TAX AUTHORITIES**

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities including open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law. 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, permitting the offset of such losses, denies the claim; if HMRC's position is found

to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Group's deferred tax asset of approximately £400 million. The Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due. 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 these 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. The Group will respond as appropriate to this and any investigations, proceedings, or regulatory action that may in due course be instigated as a result of these issues. The FCA has issued a consultation on new 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 output from this consultation is expected in the first quarter of 2017.



## BUSINESS

### **UPDATE TO THE FINANCIAL CONDUCT AUTHORITY'S ANNOUNCEMENT IN NOVEMBER 2015 ON A DEADLINE FOR PPI COMPLAINTS AND PLEVIN V PARAGON PERSONAL FINANCE LIMITED**

On 2 August 2016, the Financial Conduct Authority (FCA) published a further consultation paper (CP16/20: Rules and guidance on payment protection insurance complaints: feedback on CP15/39 and further consultation), following on from the original consultation published in November 2015. The consultation papers proposed the introduction of a two year industry deadline by which consumers would need to make their PPI complaints and rules and guidance that should apply when firms handle PPI complaints in light of the UK Supreme Court's decision in Plevin v Paragon Personal Finance Limited [2014] UKSC 61. On 2 March 2017 the FCA confirmed that the deadline would be 29 August 2019, and new rules for Plevin would come into force in August 2017.

### **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.

### **HBOS READING – CUSTOMER REVIEW**

The Group is commencing 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 review is at an early stage and it is currently not possible to determine the ultimate financial impact on the Group.

### **CONTINGENT LIABILITIES IN RESPECT OF 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. 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.

## **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, commercial and corporate banking, general insurance, and life, pensions and investment provision.

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

*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.*

*See Regulation – Competition Regulation.*

## **RECENT DEVELOPMENTS**

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

The audited consolidated financial statements set forth in the Group's Annual Report and Accounts published on 22 February 2017 were approved on 21 February 2017. As discussed in notes 38 and 55 of the audited consolidated financial statements included in this Annual Report on Form 20-F (which were approved on 10 March 2017 and which therefore include the impact of adjusting post balance sheet events up to this date), on 2 March 2017 the FCA confirmed that the deadline by which consumers will need to make their PPI complaints will be 29 August 2019 and that the final rules and guidance that should apply when firms handle PPI complaints in light of Plevin will come into force in August 2017. The Group has reassessed its provisioning in light of this guidance, leading to an additional charge of £350 million, bringing the total charge for the year ended 31 December 2016 to £1,350 million.

## 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.

## TABLE OF CONTENTS

<u>Overview and trend information</u>	11
<u>Critical accounting policies</u>	12
<u>Future accounting developments</u>	12
<u>Results of operations – 2016, 2015 and 2014</u>	13
<u>Line of business information</u>	24
<u>Average balance sheet and net interest income</u>	35
<u>Changes in net interest income – volume and rate analysis</u>	37
<u>Risk overview</u>	38
<u>Risk management</u>	44
<u>Risk governance</u>	50
<u>Credit risk</u>	53
<u>Loan portfolio</u>	75
<u>Risk elements in the loan portfolio</u>	81
<u>Conduct risk</u>	86
<u>Market risk</u>	87
<u>Operational risk</u>	93
<u>Funding and liquidity risk</u>	95
<u>Capital risk</u>	101
<u>Regulatory and legal risk</u>	108
<u>Insurance risk</u>	109
<u>People risk</u>	110
<u>Financial reporting risk</u>	111
<u>Governance risk</u>	111

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OVERVIEW AND TREND INFORMATION**

**MARKET OVERVIEW**

**GIVEN THE GROUP'S UK FOCUS, ITS FINANCIAL PERFORMANCE IS INEXTRICABLY LINKED TO THE PERFORMANCE OF THE UK ECONOMY AND ITS REGULATORY AND COMPETITIVE ENVIRONMENT**

**ECONOMIC ENVIRONMENT**

**RESILIENT UK ECONOMY POST REFERENDUM**

During 2016 the UK economy performed broadly in line with market expectations at the start of the year despite the decision to leave the European Union and significant changes in the political landscape, both in the UK and abroad.

Although post referendum most forecasters were predicting a reduction in growth, in practice growth has been resilient and the UK economy is estimated to have grown by 2 per cent in 2016, just shy of 2.2 per cent in 2015. Business and consumer confidence did fall immediately post referendum, but most of this has now been recovered and consumers' retail spending growth actually accelerated in the months after the referendum.

Manufacturers are expecting exports to benefit from the weaker pound, but confidence in the service sector has weakened. Towards the end of 2016 inflation started to rise and is likely to become a bigger headwind to consumers' spending growth through the coming year.

UK house prices increased by around 7 per cent during the year, largely driven by strong growth in the first quarter. Prices have continued to increase, albeit at slower rates, during the rest of the year in almost all geographic areas, although the most expensive parts of London have seen some reductions over the last six months.

**GROWTH IN THE GROUP'S MARKETS**

Household and business deleveraging since 2009 has created capacity for an increased pace of borrowing and the markets in which the Group operates continued to grow in 2016. Specifically:

Mortgage market growth increased to 3 per cent, from 2.7 per cent in 2015, the strongest since 2007, and although buy-to-let growth was impacted by the change in stamp duty policy in April, it still grew significantly faster than the market as a whole

Unsecured consumer credit growth rose to 8 per cent led by motor finance. Although the strongest growth since before the financial crisis, the level of unsecured debt remains close to a 20 year low relative to households' income

Business borrowing from banks increased by 2 per cent, the first growth since 2008, and SMEs by 2 per cent also

Household deposit growth rose to 6 per cent, the strongest since 2008

Business deposit growth weakened, to 6 per cent, but remains strong after three years of elevated growth and a very high level of liquidity

## **INTEREST RATES LOW FOR LONGER**

Interest rates remain at historical lows with the base rate having been cut to 0.25 per cent in August, and are expected to remain low in the foreseeable future. Market rates currently imply an increase to the base rate to 0.5 per cent during 2018, and to 0.75 per cent a year later. This flattening of the yield curve along with continued competition has meant bank margins remain under pressure. Significant competition has meant lending rates across the market remain low, particularly in mortgages, although deposit rates have fallen further during the year, offsetting the impact of lower lending rates.

## **IMPAIRMENT EXPECTED TO REMAIN BENIGN**

Improving indebtedness, along with the continued low interest rate environment, is continuing to keep impairment levels low and they remain below through-the-cycle levels.

The expected mild rise in unemployment is likely to lead to an increase in impairment from the very low level of 2016, but it should remain low over the longer term.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### OUTLOOK FOR 2017

How the economy evolves in 2017 is highly dependent on the type of EU-exit deal that companies expect to be achieved in 2019, how deeply that impacts investment and employment plans, and how much squeezed consumer spending power is offset by improved competitiveness of exports following the fall in sterling. Each of these carries a high degree of uncertainty.

The UK economic environment will also continue to be impacted by global uncertainties including the slowdown in China, European elections and the global trade environment, particularly in light of the recent US presidential election.

The consensus expectation is that UK GDP growth will slow from 2 per cent in 2016 to 1.6 per cent in 2017, and unemployment will remain low, but will rise from 4.9 per cent at the end of 2016 to 5.2 per cent at the end of 2017. House prices are expected to continue to rise, by around 3 per cent, supported by the ongoing shortage of property for sale, low levels of housebuilding and exceptionally low interest rates, while commercial real estate prices are expected to fall by 4 per cent.

If the economy evolves in line with this consensus view, the Group would expect growth across its markets to remain broadly stable in aggregate, with a mild weakening in the growth of unsecured consumer credit and commercial real estate lending offset by a marginal rise in mortgages and other lending to businesses.

### 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 56 to the financial statements.

12

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## RESULTS OF OPERATIONS – 2016, 2015 AND 2014

## SUMMARY

	2016	2015	2014
	£m	£m	£m
Net interest income	<b>9,274</b>	11,318	10,660
Other income	<b>30,337</b>	11,832	19,232
<b>Total income</b>	<b>39,611</b>	23,150	29,892
Insurance claims	<b>(22,344)</b>	(5,729 )	(13,493 )
<b>Total income, net of insurance claims</b>	<b>17,267</b>	17,421	16,399
Operating expenses	<b>(12,627)</b>	(15,387)	(13,885)
<b>Trading surplus</b>	<b>4,640</b>	2,034	2,514
Impairment	<b>(752 )</b>	(390 )	(752 )
<b>Profit before tax</b>	<b>3,888</b>	1,644	1,762
Taxation	<b>(1,724 )</b>	(688 )	(263 )
<b>Profit for the year</b>	<b>2,164</b>	956	1,499
Profit attributable to ordinary shareholders	<b>1,651</b>	466	1,125
Profit attributable to other equity holders <sup>1</sup>	<b>412</b>	394	287
Profit attributable to equity holders	<b>2,063</b>	860	1,412
Profit attributable to non-controlling interests	<b>101</b>	96	87
<b>Profit for the year</b>	<b>2,164</b>	956	1,499

The profit after tax attributable to other equity holders of £412 million (2015: £394 million; 2014: £287 million) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £91 million (2015: £80 million; 2014: £62 million).

## 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 is 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 has been a reduction in profit before tax of £818 million.

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 AND FINANCIAL REVIEW AND PROSPECTS

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 charge of £1,724 million compared to a tax charge 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.

The Group has 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 remains good, with liquidity coverage ratio (LCR) eligible assets of £121 billion. LCR eligible assets represent 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 continues to exceed regulatory requirements.

The Group has 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 is 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 has increased by 13 per cent, from 2.25 pence in 2015 and is in line with the Group's progressive and sustainable ordinary dividend policy. The Group continues to expect ordinary dividends to increase over the medium term with a dividend payout ratio of at least 50 per cent of sustainable earnings.

## **2015 COMPARED WITH 2014**

During the year ended 31 December 2015, the Group recorded a profit before tax of £1,644 million compared with a profit before tax in 2014 of £1,762 million. The result in 2015 included provisions in respect of redress to customers relating to both past sales of Payment Protection Insurance, associated administrative costs and other matters of £4,837 million compared to a charge of £3,125 million in the year ended 31 December 2014; 2014 also included a past service pension credit of £822 million and a loss of £1,362 million in relation to the exchange and repurchase of Enhanced Capital Notes, neither of which were repeated in 2015. Excluding these items from both years, profit before tax was £1,054 million, or 19 per cent, higher at £6,481 million in the year ended 31 December 2015 compared to £5,427 million in the previous year, reflecting a significant reduction in expenditure in relation to the Group's Simplification programme and lower impairment charges.

The comparison of results for 2015 to 2014 is 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Total income decreased by £6,742 million, or 23 per cent, to £23,150 million in 2015 compared with £29,892 million in 2014, comprising a £7,400 million decrease in other income partly offset by an increase in net interest income.

Net interest income was £11,318 million in 2015; an increase of £658 million, or 6 per cent compared to £10,660 million in 2014. There was a positive impact of £358 million in 2015 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, particularly in relation to fixed income securities; the change in population of consolidated OEICs in 2015 compared to 2014 caused an increase of £27 million in this interest expense. After adjusting for this, net interest income was £300 million, or 3 per cent, higher at £11,562 million in 2015 compared to £11,262 million in 2014 reflecting an improvement in margin in the Group's banking operations, driven by a combination of lower deposit and wholesale funding costs, partly offset by continued pressure on asset prices. Average interest-earning assets fell as a result of the sale of TSB and the continued run down of the portfolio of assets which are outside of the Group's risk appetite.

Other income was £7,400 million, or 38 per cent, lower at £11,832 million in 2015 compared to £19,232 million in 2014. Fee and commission income was £407 million, or 11 per cent, lower at £3,252 million compared to £3,659 million in 2014. Fee and commission expense increased by £40 million, or 3 per cent, to £1,442 million compared with £1,402 million in 2014. The decrease in net fee and commission income largely reflects the disposals of TSB and Scottish Widows Investment Partnership. Net trading income decreased by £6,445 million, or 63 per cent, to £3,714 million in 2015 compared to £10,159 million in 2014; this decrease reflected a reduction of £6,146 million in gains on policyholder investments held within the insurance business as a result of market conditions over 2015 relative to those in 2014. The reduction in trading income within the insurance business was coupled with a small decrease of £266 million in the Group's other operations. Insurance premium income was £2,333 million, or 33 per cent, lower at £4,792 million in 2015 compared with £7,125 million in 2014; there was a decrease of £2,334 million in life insurance premiums and a £1 million increase in general insurance premiums. Premium income in 2015 has 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 £375 million, or 6 per cent, lower at £5,880 million in 2015 compared to £6,255 million in 2014. Other operating income was £1,825 million higher at £1,516 million in 2015 compared to a deficit of £309 million in 2014. Other operating income includes the results of liability management from which the Group incurred a loss of £28 million in 2015 compared to a loss of £1,386 million in 2014, which was principally in relation to exchange and repurchase transactions in respect of the Group's Enhanced Capital Notes. Excluding the impact of liability management activities, other operating income was £467 million, or 43 per cent, higher at £1,544 million in 2015 compared to £1,077 million in 2014; in part reflecting a reduction in the losses arising from the movement in the value of in-force insurance business.

Insurance claims expense was £7,764 million, or 58 per cent, lower at £5,729 million in 2015 compared to £13,493 million in 2014. The insurance claims expense in respect of life and pensions business was £7,804 million, or 59 per cent, lower at £5,359 million in 2015 compared to £13,163 million in 2014; this decrease was matched by a similar decline in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £40 million or 12 per cent, higher at £370 million in 2015 compared to £330 million in 2014.

Operating expenses increased by £1,502 million, or 11 per cent to £15,387 million in 2015 compared with £13,885 million in 2014; the main reasons for the increase being the £1,712 million increase in charges for redress payments to customers in respect of PPI and other conduct related matters from £3,125 million in 2014 to £4,837 million in 2015, a charge of £665 million in 2015 in relation to the disposal of TSB and a net past service pension credit of £822 million in 2014 which was not repeated in 2015. Excluding these items from both years, operating expenses were £1,697 million, or 15 per cent, lower at £9,885 million in 2015 compared to £11,582 million in 2014. On this basis staff costs were £890 million, or 16 per cent, lower at £4,677 million in 2015 compared with £5,567 million in 2014; annual pay rises being more than offset by the impact of headcount reductions resulting from business disposals and the Group's rationalisation programmes and a reduction in severance costs as this phase of the Simplification programme draws to a close. Premises and equipment costs were £176 million or 20 per cent, lower at £715 million in 2015 compared with £891 million in 2014. Other expenses, excluding the charges in respect of customer redress provisions and the charge relating to the TSB disposal, were £808 million, or 25 per cent, lower at £2,381 million in 2015 compared with £3,189 million in 2014 as a result of lower levels of technology spend, advertising and professional fees, in particular relating to Simplification and the costs of TSB separation in 2014. Depreciation and amortisation costs were £177 million, or 9 per cent, higher at £2,112 million in 2015 compared to £1,935 million in 2014.

Impairment losses decreased by £362 million, or 48 per cent, to £390 million in 2015 compared with £752 million in 2014. Impairment losses in respect of loans and advances to customers were £292 million, or 40 per cent, lower at £443 million in 2015 compared with £735 million in 2014. The overall performance of the portfolio reflects a significant reduction in lending which is outside of the Group's risk appetite and improvements in all divisions. The net charge has also benefited from significant provision releases but at lower levels than seen in 2014. There was a credit of £55 million in respect of undrawn commitments in 2015, compared to a charge of £10 million in 2014, a result of improvements in credit quality in a number of corporate relationships.

In 2015, the Group recorded a tax charge of £688 million compared to a tax charge of £263 million in 2014, an effective tax rate of 42 per cent, which was higher than the standard UK corporation tax rate of 20.25 per cent; principally as a result of the disallowance of a substantial proportion of the Group's charge in respect of PPI and other conduct risk issues. The tax charge of £263 million in 2014 arose on a profit before tax of £1,762 million; this tax charge reflected tax exempt gains on the sale of businesses.

On the balance sheet, total assets were £48,208 million, or 6 per cent, lower at £806,688 million at 31 December 2015 compared to £854,896 million at 31 December 2014, largely due to the disposal of TSB. Loans and advances to customers were £27,529 million, or 6 per cent, lower at £455,175 million at 31 December 2015 compared to £482,704 million at 31 December 2014, with £21,643 million of the reduction being due to the sale of TSB, the continued reduction in the portfolio of assets which are outside of the Group's risk appetite and a £5,148 million reduction in reverse repurchase agreement balances have more than offset growth in the UK consumer finance business. An increase of £7,925 million in cash and balances at central banks has been more than offset by an £11,395 million reduction in trading and other financial assets at fair value through profit or loss and a £6,661 million reduction in derivative assets. Total liabilities were £45,285 million, or 6 per cent, lower at £759,708 million at 31 December 2015 compared to £804,993 million at 31 December 2014, again largely due to the sale of TSB. Customer deposits were £28,741 million, or 6 per cent, lower at £418,326 million at 31 December 2015 compared to £447,067 million at 31 December 2014 with £24,625 million of the reduction being due to the sale of TSB. Decreases of £10,239 million in trading and other financial liabilities at fair value through profit or loss and £11,095 million in insurance and



investment contract liabilities have been partly offset by increases of £6,038 million in deposits by banks and £5,823 million in debt securities in issue as the Group took advantage of favourable funding opportunities. Total equity was £2,923 million, or 6 per cent, lower at £46,980 million at 31 December 2015 compared to £49,903 million at 31 December 2014; this reflected the fact that retained profit for the year has been more than offset by negative reserve movements in respect of available-for-sale revaluation and cash flow hedging reserves, dividends paid and the adjustment to non-controlling interests on the deconsolidation of TSB.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group has maintained its capital position, with a common equity tier 1 (CET1) ratio of 12.8 per cent, (31 December 2014: 12.8 per cent) as the impact of the lower capital base (as a result of reduced levels of equity) has been offset by a reduction in risk-weighted assets.

Risk-weighted assets reduced by £16,986 million, or 7 per cent, to £222,747 million, at 31 December 2015 compared to £239,734 million at 31 December 2014, primarily driven by the sale of TSB, reductions in the portfolio of assets which are outside of the Group's risk appetite and continued improvements in credit quality offset by targeted lending growth.

The Group's liquidity position remains good, with liquidity coverage ratio (LCR) eligible assets of £123 billion. LCR eligible assets represent almost 5.7 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 2015 thus providing a buffer in the event of market dislocation. The Group's LCR ratio already exceeds regulatory requirements and is greater than 100 per cent.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## NET INTEREST INCOME

	<b>2016</b>	2015	2014
Net interest income £m	<b>9,274</b>	11,318	10,660
Average interest-earning assets £m	<b>600,435</b>	614,917	634,910
Average rates:			
Gross yield on interest-earning assets % <sup>1</sup>	<b>2.77</b>	2.86	3.03
Interest spread % <sup>2</sup>	<b>1.33</b>	1.67	1.52
Net interest margin % <sup>3</sup>	<b>1.54</b>	1.84	1.68

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

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

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

## 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; margins in Consumer Finance

fell, largely due to the focus on high quality, lower margin motor finance 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.

## 2015 COMPARED WITH 2014

Net interest income was £11,318 million in 2015 an increase of £658 million, or 6 per cent, compared to £10,660 million in 2014. Net interest income in 2015 includes a charge of £244 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a charge in 2014 of £602 million; the change in population of consolidated OEICs in 2015 compared to 2014 caused an increase of £27 million in this interest expense. After adjusting for this, net interest income was £300 million, or 3 per cent, higher at £11,562 million in 2015 compared to £11,262 million in 2014.

Average interest-earning assets were £19,993 million, or 3 per cent, lower at £614,917 million in 2015 compared to £634,910 million in 2014. The reduction reflected the sale of TSB (leading to a year-on-year reduction of £17,309 million) and the continuing run-off of assets which are outside of the Group's risk appetite.

Average interest-earning assets in Retail were £1,581 million, or 1 per cent, lower at £307,001 million in 2015 compared to £308,582 million in 2014 and average interest-earning assets in Commercial Banking were £3,860 million, or 4 per cent, lower at £90,019 million in 2015 compared to £93,879 million in 2014. Average interest-earning assets across the rest of the Group were £14,552 million, or 6 per cent, lower at £217,897 million in 2015 compared to £232,449 million in 2014. The main driver for this reduction being the decrease of £17,309 million resulting from the sale of TSB and in the portfolio of assets which are outside of the Group's risk appetite, partly offset by growth in Consumer Finance and in non-relationship balances.

The net interest margin was 16 basis points higher at 1.84 per cent in 2015 compared to 1.68 per cent in 2014, however adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 11 basis points higher at 1.88 per cent in 2015 compared to 1.77 per cent in 2014. Margins in Retail increased, driven by improved deposit margin and mix, more than offsetting reduced lending rates; however margins in Consumer Finance were down due to the acquisition of lower risk but lower margin new business and the impact of the planned reduction in deposits in line with Group's funding strategy. Margins on relationship lending and similar interest-earning assets in Commercial Banking increased due to disciplined pricing on new lending and deposits, with a reduction in wholesale funding costs led by continued progress in attracting high quality deposits.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## OTHER INCOME

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Fee and commission income:			
Current account fees	<b>752</b>	804	918
Credit and debit card fees	<b>875</b>	918	1,050
Other	<b>1,418</b>	1,530	1,691
	<b>3,045</b>	3,252	3,659
Fee and commission expense	<b>(1,356)</b>	(1,442)	(1,402)
Net fee and commission income	<b>1,689</b>	1,810	2,257
Net trading income	<b>18,545</b>	3,714	10,159
Insurance premium income	<b>8,068</b>	4,792	7,125
Gains on sale of available-for-sale financial assets	<b>575</b>	51	131
Liability management	<b>(598)</b>	(28)	(1,386)
Other	<b>2,058</b>	1,493	946
Other operating income	<b>2,035</b>	1,516	(309)
<b>Total other income</b>	<b>30,337</b>	11,832	19,232

## 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 £14,798 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

**2015 COMPARED WITH 2014**

Other income was £7,400 million, or 38 per cent, lower at £11,832 million in 2015 compared to £19,232 million in 2014.

Fee and commission income was £407 million, or 11 per cent, lower at £3,252 million in 2015 compared with £3,659 million in 2014. Current account fees were £114 million, or 12 per cent, lower at £804 million in 2015 compared to £918 million in 2014, with £75 million of the reduction being a result of the sale of TSB. A decrease of £132 million, or 13 per cent, in credit and debit card fees from £1,050 million in 2014 to £918 million in 2015 resulted from the sale of TSB (£51 million of the decrease) and reduced interchange income due to changes in regulation. Other fees and commissions receivable were £161 million, or 10 per cent lower at £1,530 million in 2015 compared with £1,691 million in 2014; again partly reflecting the sale of TSB and also Scottish Widows Investment Partnership in 2014.

Fee and commission expense was £40 million, or 3 per cent, higher at £1,442 million in 2015 compared to £1,402 million in 2014; despite a £63 million decrease as a result of the sale of TSB and Scottish Widows Investment Partnership; the underlying increase reflects increased levels of fees payable in respect of transactions in Commercial Banking and for asset management services in Insurance.

Net trading income was £6,445 million, or 63 per cent, lower at £3,714 million in 2015 compared with £10,159 million in 2014. Net trading income within the insurance businesses was £6,146 million, or 69 per cent, lower at £2,774 million in 2015 compared to £8,920 million in 2014, which reflects lower levels of returns on policyholder investments as a result of market conditions over 2015 relative in those in 2014. However this decrease, along with the decrease in long-term insurance premium income, was largely offset by the decrease in insurance claims expense and the £358 million decrease 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 £299 million, or 24 per cent, lower at £940 million in 2015 compared to £1,239 million in 2014; in particular this decrease reflected a charge of £101 million for the movement in fair value of the equity conversion feature of the Group's Enhanced Capital Notes, compared to a gain of £401 million in the year ended 31 December 2014.

Insurance premium income was £4,792 million in 2015 compared with £7,125 million in 2014; a decrease of £2,333 million, or 33 per cent. Premium income in 2015 has 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 £375 million, or 6 per cent, lower at £5,880 million in 2015 compared to £6,255 million in 2014 with the impact of regulatory and market change more than offsetting income from the new bulk annuities business. General insurance earned premiums were little changed, just £1 million higher at £871 million in 2015 compared with £870 million in 2014 reflecting competitive market

conditions and the run-off of products closed to new customers.

Other operating income was £1,825 million higher at £1,516 million in 2015 compared to a deficit of £309 million in 2014. In April 2014, the Group had completed exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) to exchange the ECNs for new Additional Tier 1 (AT1) securities and a tender offer to eligible retail holders outside the United States to sell their Sterling-denominated ECNs for cash; a loss of £1,362 million was recognised in relation to these exchange and tender transactions in the year ended 31 December 2014. Excluding this item, other operating income was £463 million, or 44 per cent, higher at £1,516 million in 2015 compared to £1,053 million in 2014; this reflected a £266 million improvement in the movement in value of in-force insurance business and a £39 million increase in operating lease rental income.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## OPERATING EXPENSES

	2016 £m	2015 £m	2014 £m
Administrative expenses:			
Staff:			
Salaries	2,750	2,808	3,178
Performance-based compensation	475	409	390
Social security costs	363	349	398
Pensions and other post-retirement benefit schemes:			
Past service credits and curtailment gains	–	–	(822 )
Other	555	548	596
	555	548	(226 )
Restructuring costs	241	104	264
Other staff costs	433	459	741
	4,817	4,677	4,745
Premises and equipment:			
Rent and rates	365	368	424
Repairs and maintenance	187	173	221
Other	120	174	246
	672	715	891
Other expenses:			
Communications and data processing	848	893	1,118
Advertising and promotion	198	253	336
Professional fees	265	262	481
UK bank levy	200	270	237
TSB disposal	–	665	–
Other	873	703	1,017
	2,384	3,046	3,189
Depreciation and amortisation:			
Depreciation of tangible fixed assets	1,761	1,534	1,391
Amortisation of acquired value of in-force non-participating investment contracts	37	41	43
Amortisation of other intangible assets	582	537	501
	2,380	2,112	1,935
Total operating expenses, excluding regulatory provisions	10,253	10,550	10,760
Regulatory provisions:			
Payment protection insurance provision	1,350	4,000	2,200
Other regulatory provisions <sup>1</sup>	1,024	837	925
	2,374	4,837	3,125
<b>Total operating expenses</b>	<b>12,627</b>	<b>15,387</b>	<b>13,885</b>
Cost:income ratio (%) <sup>2</sup>	73.1	88.3	84.7

<sup>1</sup> In addition, £61 million (2015: £nil; 2014: £nil) of regulatory provisions have been charged against income.

<sup>2</sup> Total operating expenses divided by total income, net of insurance claims.

## 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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. For further details see note 38 to the financial statements.

### **2015 COMPARED WITH 2014**

Operating expenses increased by £1,502 million, or 11 per cent, to £15,387 million in 2015 compared with £13,885 million in 2014. This increase principally reflected the fact that 2014 included a past service pension credit of £822 million and 2015 includes a regulatory provisions charge of £4,837 million, which was £1,712 million, or 54 per cent, higher than the charge of £3,125 million in 2014.

The past service pension credit of £822 million in 2014 followed the Group's decision, announced on 11 March 2014 to reduce the cap on increases in pensionable pay used in calculating the pension benefit to nil with effect from 2 April 2014.

Despite the past service pension credit in 2014, staff costs were £68 million, or 1 per cent, lower in 2015 at £4,677 million compared to £4,745 million in 2014. Excluding the pension credit, staff costs were £890 million, or 16 per cent, lower at £4,677 million in 2015 compared to £5,567 million in 2014 reflecting, in particular, the impact of business disposals and a significant reduction in expenditure in relation to the Group's Simplification programme. As a result, salaries were £370 million, or 12 per cent, lower at £2,808 million in 2015 compared with £3,178 million in 2014; pension costs, excluding the past service pension credit from 2014, were £48 million, or 8 per cent, lower at £548 million in 2015 compared to £596 million in 2014; social security costs were £49 million, or 12 per cent, lower at £349 million in 2015 compared with £398 million in 2014; staff restructuring costs were £160 million, or 61 per cent, lower at £104 million in 2015 compared with £264 million in 2014; and other staff costs were £282 million, or 38 per cent, lower at £459 million in 2015 compared with £741 million in 2014, in particular due to lower levels of agency staff costs in relation to the Simplification programme.

Premises and equipment costs were £176 million, or 20 per cent, lower at £715 million in 2015 compared to £891 million in 2014, again reflecting business disposals and reduced Simplification expenditure. Rent and rates was £56 million, or 13 per cent, lower at £368 million in 2015 compared to £424 million in 2014; repairs and maintenance costs were £48 million, or 22 per cent, lower at £173 million in 2015 compared to £221 million in 2014, in part due to a lower level of dilapidation provisions on vacation of properties in 2015 than in 2014; and other premises and equipment costs decreased by £72 million, or 29 per cent, from £246 million in 2014 to £174 million in 2015, reflecting lower levels of losses on sale of equipment and a reduced level of activity in the property portfolio.

Other expenses, excluding the regulatory provisions charges, were £143 million, or 4 per cent, lower at £3,046 million in 2015 compared with £3,189 million in 2014. Communications and data processing costs were £225 million, or 20 per cent, lower at £893 million in 2015 compared with £1,118 million in 2014 as a result of a significant reduction in Simplification spend on systems and technology; professional fees were £219 million, or 46 per cent, lower at £262 million in 2015 compared to £481 million in 2014, reflecting both the reduced Simplification spend and a lower level of professional fees in respect of TSB; and advertising and promotion costs were £83 million, or 25 per cent, lower at £253 million in 2015 compared with £336 million in 2014 due to spend in relation to TSB in 2014. The cost of the Bank levy was £33 million, or 14 per cent, higher at £270 million in 2015 compared to £237 million in 2014, as a result of the increase in rate with effect from 1 April 2015. In 2015 the Group incurred a charge of £665 million relating to the disposal of TSB, reflecting the net costs of the Transitional Service Agreement between Lloyds and TSB and the contribution to be provided by Lloyds to TSB in moving to alternative IT provision. Other costs were £314 million, or 31 per cent, lower at £703 million in 2015 compared with £1,017 million in 2014.

Depreciation and amortisation costs were £177 million, or 9 per cent, higher at £2,112 million in 2015 compared with £1,935 million in 2014. Charges for the depreciation of tangible fixed assets were £143 million, or 10 per cent, higher at £1,534 million in 2015 compared to £1,391 million in 2014, in line with increased asset balances. The charge for the amortisation of acquired value of in-force non-participating investment contracts was £2 million, or 5 per cent, lower at £41 million in 2015 compared to £43 million in 2014. The charge for the amortisation of other intangible assets was £36 million, or 7 per cent, higher at £537 million in 2015 compared to £501 million in 2014, reflecting increased capitalised software balances.

The Group incurred a regulatory provisions charge in operating expenses of £4,837 million in 2015 compared to £3,125 million in 2014 of which £4,000 million (2014: £2,200 million) related to payment protection insurance.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**IMPAIRMENT**

	2016	2015	2014
	£m	£m	£m
Impairment losses on loans and receivables:			
Loans and advances to customers	592	443	735
Debt securities classified as loans and receivables	–	(2 )	2
Total impairment losses on loans and receivables	592	441	737
Impairment of available-for-sale financial assets	173	4	5
Other credit risk provisions	(13 )	(55 )	10
<b>Total impairment charged to the income statement</b>	<b>752</b>	<b>390</b>	<b>752</b>

**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; and in Consumer Finance were as a result of overall growth 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

**2015 COMPARED WITH 2014**

Impairment losses decreased by £362 million, or 48 per cent, to £390 million in 2015 compared to £752 million in 2014, largely due to reduced charges in relation to the portfolio of assets which are outside of the Group's risk appetite.

The impairment charge in respect of loans and advances to customers was £292 million, or 40 per cent, lower at £443 million in 2015 compared to £735 million in 2014. In Retail, a reduced impairment charge reflected continued low risk underwriting discipline, strong portfolio management and a favourable credit environment with low unemployment, increasing house prices and continued low interest rates. The improvement in Commercial Banking was driven by lower levels of new impairment as a result of effective risk management, improving UK economic conditions and the continued low interest rate environment; as well as provision releases, but at lower levels than seen during 2014. The Consumer Finance impairment charge reduced, driven by a continued underlying improvement in portfolio quality, supported by an increased level of write-backs from the sale of recoveries assets in the credit card portfolio compared to 2014 due to favourable market conditions. The impairment charge relating to assets which are outside of the Group's risk appetite reduced significantly, reflecting the Group's ongoing exit from these positions.

The impairment charge in respect of debt securities classified as loans and receivables was a credit of £2 million in 2015 compared to a charge of £2 million in 2014. The impairment charge in respect of available-for-sale financial assets was £1 million, or 20 per cent, lower at £4 million in 2015 compared to £5 million in 2014; and there was a credit of £55 million (2014: charge of £10 million) in respect of other credit risk provisions as a result of improved credit quality in a number of corporate relationships.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## TAXATION

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
UK corporation tax:			
Current tax on profits for the year	<b>(1,010)</b>	(485)	(162)
Adjustments in respect of prior years	<b>156</b>	(90 )	213
	<b>(854 )</b>	(575)	51
Foreign tax:			
Current tax on profits for the year	<b>(20 )</b>	(24 )	(39 )
Adjustments in respect of prior years	<b>2</b>	27	3
	<b>(18 )</b>	3	(36 )
<b>Current tax (charge) credit</b>	<b>(872 )</b>	(572)	15
Deferred tax	<b>(852 )</b>	(116)	(278)
<b>Taxation charge</b>	<b>(1,724)</b>	(688)	(263)

## 2016 COMPARED WITH 2015

In 2016, a tax charge of £1,724 million arose on the profit before tax of £3,888 million and in 2015 a tax charge 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 charge for 2016 represents 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.

## 2015 COMPARED WITH 2014

In 2015, a tax charge of £688 million arose on the profit before tax of £1,644 million and in 2014 a tax charge of £263 million arose on the profit before tax of £1,762 million. The statutory corporation tax rates were 20.25 per cent for 2015 and 21.5 per cent for 2014.

The tax charge for the 2015 represented an effective tax rate of 42 per cent. The effective tax rate was higher than the UK corporation tax rate largely due to the introduction in 2015 of restrictions on the deductibility of conduct related



provisions which resulted in an additional tax charge of £459 million. Adjusting for this charge, the effective tax rate would have been 14 per cent reflecting non-taxable and relieved gains and a number of positive one-off items.

The low tax charge in 2014 was driven by tax exempt gains on sales of businesses and a lower deferred tax liability in respect of the value of in-force assets in the life business.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### LINE OF BUSINESS INFORMATION

The requirements for IFRS segmental reporting are set out in IFRS 8, *Operating Segments* which mandates that an entity's segmental reporting should reflect the way in which its operations are viewed and judged by its chief operating decision maker. As a consequence, the Group's statutory segmental reporting follows the 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.

The Group's activities are organised into four financial reporting segments: Retail; Commercial Banking; Consumer Finance and Insurance. The Group's unsecured personal lending portfolio, previously part of Retail, is now managed by Consumer Finance and elements of the Group's business in the Channel Islands and Isle of Man were transferred from Retail to Commercial Banking; comparatives have been restated accordingly.

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 other items, which includes the effects of certain asset sales, the impact of liability management actions, the volatility relating to the Group's own debt and hedging arrangements as well as that arising in the insurance businesses, insurance gross up, the unwind of acquisition-related fair value adjustments arising from the HBOS acquisition, and the amortisation of purchased intangible assets;

restructuring costs (which in 2015 and 2016 comprised severance related costs relating to the Simplification programme announced in October 2014 and in 2014 included severance, IT and business costs relating to the programme started in 2011) and the costs of implementing regulatory reform, ring fencing and rationalisation of the non-branch property portfolio;

-TSB build and dual running costs and the loss relating to the TSB sale in 2015;

-payment protection insurance and other conduct provisions; and

-certain past service pensions charges and credits in respect of the Group's defined benefit pension arrangements.

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

	<b>2016</b>	2015 <sup>1</sup>	2014 <sup>1</sup>
	<b>£m</b>	£m	£m
Retail	<b>3,003</b>	3,091	2,739
Commercial Banking	<b>2,468</b>	2,478	2,256
Consumer Finance	<b>1,283</b>	1,381	1,449
Insurance	<b>837</b>	962	922
Other	<b>276</b>	200	390
<b>Underlying profit before tax</b>	<b>7,867</b>	8,112	7,756

<sup>1</sup> Segmental analysis restated, as explained above.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Note	2016 £m	2015 £m	2014 £m
<b>Underlying profit before tax</b>		<b>7,867</b>	8,112	7,756
Asset sales	1	217	54	138
Enhanced Capital Notes	2	(790)	(101)	(961)
Liability management	3	123	(28)	(24)
Own debt volatility	4	(11)	127	(3)
Other volatile items	5	201	(129)	(112)
Volatility arising in insurance businesses	6	(91)	(105)	(228)
Restructuring and TSB build and dual running costs	8	(622)	(255)	(1,524)
Charge relating to TSB disposal	9	–	(660)	–
Payment protection insurance provision	10	(1,350)	(4,000)	(2,200)
Other conduct provisions	11	(1,085)	(837)	(925)
Past service pension credit	12	–	–	710
Amortisation of purchased intangibles	13	(340)	(342)	(336)
Fair value unwind and other items	14	(231)	(192)	(529)
<b>Statutory profit before tax</b>		<b>3,888</b>	1,644	1,762

**1. Asset sales**

Asset sales comprise the gains and losses on asset disposals (2016: gains of £217 million; 2015: gains of £54 million; 2014: gains of £138 million), including assets which were outside of the Group's risk appetite; the gain in the year ended 31 December 2016 includes the gain of £484 million on the sale of the Group's investment in Visa Europe.

**2. 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.

In April 2014, the Group completed exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) to exchange the ECNs for new Additional Tier 1 (AT1) securities and completed a tender offer to eligible retail holders outside the United States to sell their Sterling-denominated ECNs for cash. A loss of £1,362 million was

recognised in relation to these exchange and tender transactions in the year ended 31 December 2014; partly offset by a gain of £401 million arising from the change in fair value of the remaining embedded equity conversion feature.

### **3. Liability management**

Gains of £123 million (2015: losses of £28 million; 2014: losses of £24 million) arose on other transactions undertaken as part of the Group's management of wholesale funding and capital. The liability management gains and losses were included in other income.

### **4. Own debt volatility**

Own debt volatility includes a £31 million loss (2015: gain of £114 million; 2014: gain of £33 million) relating to the change in fair value of the small proportion of the Group's wholesale funding which was designated at fair value at inception.

### **5. Other volatile items**

Other volatile items include the change in fair value of interest rate derivatives and foreign exchange hedges in the banking book not mitigated through hedge accounting. A gain of £259 million was included in 2016 (2015: charge of £99 million; 2014: charge of £138 million). Also included in 2016 was a negative net derivative valuation adjustment of £58 million (2015: charge of £30 million; 2014: credit of £26 million), reflecting movements in the market implied credit risk associated with customer derivative balances.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**6. Volatility arising in insurance businesses**

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

In 2016, the Group's statutory result before tax included negative insurance and policyholder interests volatility totalling £91 million compared to negative volatility of £105 million in 2015 and negative volatility of £228 million in 2014.

Volatility comprises the following:

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Insurance volatility	<b>(152)</b>	(303)	(219)
Policyholder interests volatility	<b>241</b>	87	17
Insurance hedging arrangements	<b>(180)</b>	111	(26 )
<b>Total</b>	<b>(91 )</b>	(105)	(228)

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 negative insurance volatility during 2016 of £152 million primarily reflects reductions in yields, widening credit spreads and low returns on cash investments partially offset by 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 charge 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 2016, the statutory results before tax included a credit to other income which relates to policyholder interests volatility totalling £241 million reflecting movements in equity, bond and gilt returns relating to life products.

*Insurance hedging arrangements*

The Group purchased put option contracts in 2016 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 £180 million was recognised in relation to these contracts in 2016 which was less than the gain from the underlying exposure.

**7. Insurance gross-up**

The Group's insurance businesses' income statements include income and expenditure which are attributable to the policyholders of the Group's long-term assurance funds. These items have no impact in total upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the business, these items are shown net on a separate line. These policyholder amounts relate principally to returns on policyholder investments (within net interest income and net trading income) and insurance premiums receivable, together with a matching amount within the insurance claims expense representing the allocation of these items to policyholders.

**8. Restructuring costs and TSB build and dual-running costs**

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. The costs of £966 million in 2014 related to phase 1 of the Simplification programme which was completed in 2014.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

During 2015, the Group completed the European Commission (EC) mandated business disposal of TSB. TSB costs in the year ended 31 December 2015 totalled £85 million (2014: £558 million) relating to dual-running costs. The dual-running costs include the costs of TSB's standalone treasury, finance, human resources and other head office functions.

### **9. 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.

### **10. Payment protection insurance (PPI) provision**

A provision of £1,350 million to cover further operating costs and redress relating to PPI was recognised in the 2016 (2015: £4,000 million; 2014: £2,200 million). The charge of £1,350 million in 2016 was largely driven by a higher total volume of complaints expected as a result of the Financial Conduct Authority's (FCA) industry deadline being extended to the end of August 2019 as well as changes to the rules and guidance that should apply when firms handle PPI complaints in light of the UK Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 (Plevin). Final rules and guidance were published by the FCA on 2 March 2017 (PS 17/3).

### **11. Other conduct provisions**

There was a charge of £1,085 million in 2016 to cover a range of other conduct issues (2015: £837 million; 2014: £925 million). The charge for the year included £280 million in respect of complaints relating to packaged bank accounts, £261 million in respect of arrears-related activities on secured and unsecured retail products and £94 million related to insurance products sold in Germany, together with a number of other conduct risk provisions totalling £450 million across all divisions.

### **12. Past service pension credit**

On 11 March 2014 the Group announced a change to its defined benefit pension arrangements, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from

2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £843 million with a corresponding curtailment gain recognised in the income statement. This was partly offset by a charge of £133 million relating to the cost of other changes to the pay, benefits and reward offered to employees to give a net credit of £710 million recognised in 2014.

### **13. 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 £340 million (2015: £342 million; 2014: £336 million).

### **14. Fair value unwind and other items**

The statutory (IFRS) results include the impact of the acquisition-related fair value adjustments 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## DIVISIONAL RESULTS

## RETAIL

Retail offers a broad range of financial service products, including current accounts, savings and mortgages, to UK personal customers, including Wealth and small business customers. It is also a distributor of insurance, protection and credit cards, and a range of long-term savings and investment products. Its aim is to be the best bank for customers in the UK, by building deep and enduring relationships that deliver real value to customers, and by providing them with greater choice and flexibility. It will maintain its multi-brand and multi-channel strategy, and continue to simplify the business and provide more transparent products, helping to improve service levels and reduce conduct risks.

	<b>2016</b>	2015 <sup>1</sup>	2014 <sup>1</sup>
	<b>£m</b>	£m	£m
Net interest income	<b>6,497</b>	6,664	6,270
Other income	<b>1,053</b>	1,115	1,202
Total income	<b>7,550</b>	7,779	7,472
Operating expenses	<b>(4,174)</b>	(4,339)	(4,239)
Impairment	<b>(373 )</b>	(349 )	(494 )
<b>Underlying profit</b>	<b>3,003</b>	3,091	2,739

<sup>1</sup> Restated, as explained on page 24.

## 2016 COMPARED WITH 2015

Underlying profit decreased by £88 million, or 3 per cent, to £3,003 million in 2016 compared to £3,091 million in 2015, reflecting the challenging interest rate environment and continued pressure on other operating income.

Net interest income decreased by £167 million, or 3 per cent, to £6,497 million in 2016 compared to £6,664 million in 2015, largely due to a reduction in mortgage balances as Retail focus on protecting margins. Banking margin fell by just 2 basis points despite the continuing low interest rate environment.

Other income decreased £62 million, or 6 per cent, to £1,053 million in 2016 compared to £1,115 million in 2015, driven by changing customer behaviour and improvements to the customer proposition.

Operating expenses decreased by £165 million, or 4 per cent, to £4,174 million in 2016 compared to £4,339 million in 2015 as efficiency savings more than covered an increase in investment. Staff numbers have reduced by 11 per cent in the year.

Impairment increased by £24 million, or 7 per cent, to £373 million in 2016 compared to £349 million in 2015. Underlying credit quality remains stable.

## **2015 COMPARED WITH 2014**

Underlying profit increased by £352 million, or 13 per cent to £3,091 million in 2015 compared to £2,739 million in 2014, driven by improved margins and reduced impairments.

Net interest income increased £394 million, or 6 per cent, to £6,664 million in 2015 compared to £6,270 million in 2014. Margin performance was strong, increasing 12 basis points to 2.22 per cent in 2015 compared to 2.10 per cent in 2014, driven by improved deposit mix and margin, more than offsetting reduced lending rates.

Other income decreased £87 million, or 7 per cent, to £1,115 million in 2015 compared to £1,202 million in 2014, driven by current account transaction related income and regulatory changes, in particular, impacting the Wealth business.

Operating expenses increased £100 million, 2 per cent, to £4,339 million in 2015 compared to £4,239 million in 2014. The increase reflects continued business investment and simplification to improve customer experiences.

Impairment reduced by £145 million, or 29 per cent, to £349 million in 2015 compared to £494 million in 2014, driven by continued low risk underwriting discipline, strong portfolio management and a favourable credit environment.

## 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 divisions – 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, debt capital markets services, as well as access to private equity through Lloyds Development Capital.

	<b>2016</b>	2015 <sup>1</sup>	2014 <sup>1</sup>
	<b>£m</b>	£m	£m
Net interest income	<b>2,735</b>	2,576	2,542
Other income	<b>1,987</b>	2,072	1,962
Total income	<b>4,722</b>	4,648	4,504
Operating lease depreciation	<b>(105 )</b>	(30 )	(24 )
<b>Net income</b>	<b>4,617</b>	4,618	4,480
Operating expenses	<b>(2,133)</b>	(2,162)	(2,139)
Impairment	<b>(16 )</b>	22	(85 )
<b>Underlying profit</b>	<b>2,468</b>	2,478	2,256

<sup>1</sup> Restated, as explained on page 24.

## 2016 COMPARED WITH 2015

Commercial Banking underlying profit decreased by £10 million, to £2,468 million in 2016 compared to £2,478 million in 2015 due to additional charges relating to certain leasing assets partially offset by total income growth.

Net interest income increased by £159 million, or 6 per cent, to £2,735 million in 2016 compared to £2,576 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 £85 million, or 4 per cent, to £1,987 million in 2016 compared to £2,072 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 £29 million to £2,133 million in 2016 compared to £2,162 million in 2015.

Impairments increased by £38 million, to £16 million charge in 2016 compared to £22 million release in 2015.

## **2015 COMPARED WITH 2014**

Commercial Banking underlying profit increased by £222 million, or 10 per cent, to £2,478 million in 2015 compared to £2,256 million in 2014 due to lower impairments and increased total underlying income partially offset by higher operating costs.

Net interest income increased by £34 million, or 1 per cent, to £2,576 million in 2015 compared to £2,542 million in 2014 driven by reduced funding costs and higher net interest margin due to disciplined new lending and an increase in deposits.

Other income increased by £110 million, or 6 per cent, to £2,072 million in 2015 compared to £1,962 million in 2014 driven by refinancing support provided to Global Corporate clients and increases in Mid Markets.

Operating lease depreciation increased by £6 million to £30 million in 2015 compared to £24 million in 2014. Operating expenses increased by £23 million, to £2,162 million in 2015 compared to £2,139 million in 2014.

Impairments improved by £107 million to a £22 million release in 2015 compared to an £85 million charge in 2014 reflecting lower gross charges and an increase in write-backs.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CONSUMER FINANCE

Consumer Finance comprises motor finance, credit cards, unsecured personal loans and its European business, which includes mortgages and deposit taking. Unsecured personal loans joined the division in 2016 in order to reposition this business for growth. This brings together all consumer lending products to enable better and more coordinated focus on these markets. Consumer Finance's aim is to deliver sustainable growth within risk appetite through building digital capability and continuing to create innovative propositions, underpinned by improvements to customer experience.

	<b>2016</b>	2015 <sup>1</sup>	2014 <sup>1</sup>
	<b>£m</b>	£m	£m
Net interest income	<b>1,941</b>	1,954	2,037
Other income	<b>1,338</b>	1,359	1,368
Total income	<b>3,279</b>	3,313	3,405
Operating lease depreciation	<b>(775 )</b>	(720 )	(667 )
Net income	<b>2,504</b>	2,593	2,738
Operating expenses	<b>(939 )</b>	(977 )	(971 )
Impairment	<b>(282 )</b>	(235 )	(318 )
<b>Underlying profit</b>	<b>1,283</b>	1,381	1,449

<sup>1</sup> Restated, as explained on page 24.

## 2016 COMPARED WITH 2015

Underlying profit was £1,283 million in 2016 compared to £1,381 million in 2015, a decrease of £98 million, or 7 per cent, driven by slightly lower income and increased impairment.

Total income decreased by £34 million to £3,279 million in 2016 compared to £3,313 million in 2015.

Net interest margin decreased by 73 basis points to 5.88 per cent, contributing to a reduction in net interest income to £1,941 million in 2016 compared to £1,954 million in 2015. Net interest margin was down due to the focus on high quality, lower margin motor finance business, with the margin also impacted by lower Euribor and planned reductions in deposits, in line with the Lloyds Banking Group's funding strategy.

Other income reduced by £21 million to £1,338 million in 2016 compared to £1,359 million in 2015, due to the market-wide reduction in credit card interchange fees, partly offset by continued fleet growth in Lex Autolease.

Operating expenses reduced by £38 million, or 4 per cent, to £939 million in 2016 compared to £977 million in 2015 with continued investment in the business more than offset by underlying efficiency savings.

The impairment charge increased by £47 million, or 20 per cent, to £282 million in 2016 compared to £235 million in 2015, primarily due to overall growth and the non-recurrence of a favourable one-off release in 2015.

## **2015 COMPARED WITH 2014**

Underlying profit was £1,381 million in 2015 compared to £1,449 million in 2014 with growth in better quality but lower margin lending resulting in lower income but lower impairments, offset by increased cost of investment in growth initiatives.

Total income decreased by £92 million to £3,313 million in 2015 compared to £3,405 million in 2014.

Net interest margin decreased by 68 basis points to 6.61 per cent, contributing to a reduction in net interest income to £1,954 million in 2015 compared to £2,037 million in 2014. Net interest margin was down due to the acquisition of lower risk but lower margin new business, an increased proportion of Black Horse lending including the partnership with Jaguar Land Rover, lower unsecured personal lending balances and the impact of the planned reduction in deposits in line with the Group's balance sheet funding strategy.

Other income reduced by £9 million to £1,359 million in 2015 compared to £1,368 million in 2014, as higher income from growing the Lex Autolease fleet was offset by the impact of lower interchange income in Cards following the recent EU ruling.

Operating expenses increased by £6 million to £977 million in 2015 compared to £971 million in 2014 as operating cost savings were offset by continued investment in growth initiatives.

The impairment charge reduced by £83 million, or 26 per cent, to £235 million in 2015 compared to £318 million in 2014. This has been driven by continued underlying improvement in portfolio quality and supported by the sale of recoveries assets in the credit card and unsecured personal lending portfolios together with a one-off release in the



motor business. The asset quality ratio improved by 28 basis points.

30

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**INSURANCE**

Insurance provides a broad range of long term savings, retirement and protection products to retail and corporate customers, either direct or through intermediary networks or through the Group's banking branches .

*Life, Pensions and Investments*

The Life, Pensions and Investments business provides long-term savings, retirement solutions and protection products primarily distributed through intermediaries and direct channels of Scottish Widows.

*General Insurance*

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

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Net interest expense	<b>(146 )</b>	(163 )	(131 )
Other income	<b>1,755</b>	1,827	1,725
Total income, net of insurance claims	<b>1,609</b>	1,664	1,594
Operating expenses	<b>(772 )</b>	(702 )	(672 )
<b>Underlying profit</b>	<b>837</b>	962	922

**2016 COMPARED WITH 2015**

Underlying profit from Insurance was £125 million, or 13 per cent lower at £837 million compared to £962 million in 2015. A 17 per cent increase in new business income was more than offset by adverse economics impacting existing business income together with increased investment costs.

Net interest expense decreased by £17 million, or 10 per cent, to £146 million from £163 million in 2015 due to lower interest rates.

Other income decreased by £72 million, or 4 per cent, to £1,755 million from £1,827 million in 2015. The decrease was driven by adverse economics impacting existing business income partly offset by growth in the planning and retirement and protection propositions and increased general insurance income.

## **2015 COMPARED WITH 2014**

Underlying profit from insurance was £40 million, or 4 per cent higher at £962 million compared to £922 million in 2014. The increase was driven by bulk annuity deals and the net benefit from a number of assumption updates, partly offset by increased costs reflecting significant investment spend, adverse economics, and reduced general insurance income.

Net interest expense increased by £32 million, or 24 per cent, to £163 million from £131 million in 2014 due to holding increased debt whilst a tranche of subordinated debt was re-financed.

Other income increased by £102 million, or 6 per cent, to £1,827 million from £1,725 million in 2014. The increase was driven by bulk annuity deals and the net benefit from a number of assumption updates, partly offset by adverse economics and reduced general insurance income.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## UNDERLYING PROFIT BY PRODUCT GROUP

	2016			2015			2014		
	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
Corporate pensions	123	135	258	140	175	315	143	164	307
Bulk annuities	121	16	137	125	–	125	–	–	–
Planning and retirement	109	95	204	40	94	134	63	123	186
Protection	19	33	52	12	37	49	46	31	77
Longstanding life, pensions and investments	9	393	402	9	467	476	16	483	499
	<b>381</b>	<b>672</b>	<b>1,053</b>	326	773	1,099	268	801	1,069
Life and pensions experience and other items			223			235			26
General Insurance			354			323			418
Net interest income and free asset return			(21 )			7			81
Total costs			(772 )			(702 )			(672 )
<b>Underlying profit</b>			<b>837</b>			<b>962</b>			<b>922</b>

## 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 corporate pensions.

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

There was a net benefit of £223 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.

General insurance income net of claims has increased by £31 million primarily driven by lower weather related claims.

Net interest income and free asset return has decreased by £28 million with benefits from lower interest rates on net interest income being more than offset by a lower expected rate of return on free assets.

Total costs were £70 million higher reflecting increased investment and £28 million annual levy associated with the Flood Re scheme.

## **2015 COMPARED WITH 2014**

New business income increased by £58 million to £326 million with the primary driver being the new bulk annuity business. This was offset by a reduction in Protection income, following the removal of face-to-face advice in branch standalone protection sales and reduced annuity income following the introduction of Pensions Freedoms in 2015. Corporate pension income remained robust despite lower sales following the auto enrolment driven increases in 2014.

Existing business income decreased by £28 million reflecting the reduction in the expected rate of return used to calculate life and pensions income. The rate of return is largely set by reference to an average 15 year swap rate (2.57 per cent in 2015 and 3.48 per cent in 2014).

Life and pensions experience and other items increased by £209 million. 2015 assumption changes and experience variances include an adverse impact of £208 million in Pensions and Investments as a result of the strengthening of lapse assumptions on the pensions book to allow for the impact of the recent pension reforms. This was more than offset by the £240 million of benefit recognised within Planning and Retirement, primarily as a result of changes to assumptions on longevity. These longevity changes reflect both experience in the annuity portfolio and the adoption of a new industry model reflecting an updated view of future life expectancy. Benefits from the long term investment strategy increased by £15 million, reflecting the successful acquisition of a further £1.4 billion of higher yielding assets to match the long duration annuity liabilities.

General Insurance income net of claims has fallen by £95 million. This reflects the run-off of products closed to new customers, the impact of becoming a sole underwriter of the home insurance business (which has resulted in a short-term reduction from the loss of commission recognised upfront) and the impact of adverse weather conditions.

Net interest income and free asset return has decreased by £74 million due to holding increased debt whilst a tranche of subordinated debt was re-financed and a lower rate of return on free assets.

Total costs were £30 million higher, reflecting significant investment spend as part of an ongoing programme of growth and simplification initiatives. In 2015 this included the launch of Protection to IFAs and the bulk annuities business alongside the Part VII transfer as well as a significant regulatory change agenda in particular to support pensions freedoms and transition to Solvency II. Excluding investment related expenditure, underlying costs fell by 3 per cent during 2015 reflecting ongoing operational efficiencies.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OTHER**

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

**Run-off**

Run-off includes assets classified as outside the Group's risk appetite and the results and gains on sale relating to businesses disposed in 2014.

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Net interest expense	<b>(110 )</b>	(88 )	(116 )
Other income	<b>120</b>	145	451
Total income	<b>10</b>	57	335
Operating lease depreciation	<b>(15 )</b>	(14 )	(29 )
Net income	<b>(5 )</b>	43	306
Operating expenses	<b>(77 )</b>	(150 )	(279 )
Impairment	<b>26</b>	(8 )	(203 )
<b>Underlying loss</b>	<b>(56 )</b>	(115 )	(176 )

**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

## 2015 COMPARED WITH 2014

The underlying loss of £115 million was £61 million lower than the loss of £176 million in 2014 as a result of both lower operating expenses and lower impairment charges as the run-off portfolios were managed down.

The reduction in total income from £335 million in 2014 to £57 million in 2015 was due to the sale of Scottish Widows Investment Partnership during 2014 and the continued reduction in run-off assets.

Operating costs were £164 million, down £144 million as a result of business disposals in 2014.

The reduction in the impairment charge from £203 million in 2014 to £8 million in 2015 reflects the continued progress in managing down the run-off portfolios.

## 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.

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Net interest income	–	192	786
Other income	–	31	140
Total income	–	223	926
Operating expenses	–	(86 )	(370 )
Impairment	–	(19 )	(98 )
<b>Underlying profit</b>	–	118	458

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OTHER** (continued)**2016 COMPARED WITH 2015**

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

**2015 COMPARED WITH 2014**

Underlying profit was £340 million, or 74 per cent, lower at £118 million in 2015 compared to £458 million in 2014; this principally reflects the fact that TSB was only consolidated for three months in 2015, compared to a full year in 2014.

Total income was £703 million, or 76 per cent, lower at £223 million in 2015 compared to £926 million in 2014; operating expenses were £284 million, or 77 per cent, lower at £86 million in 2015 compared to £370 million in 2014; and the impairment charge was £79 million, or 81 per cent, lower at £19 million in 2015 compared to £98 million in 2014.

**Central items**

Central Items includes income and expenses not recharged to the divisions. These largely comprise residual income from the Group's processes to allocate funding and liquidity costs to the divisions and the charge for payments to the Group's charitable foundations.

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
Total income	<b>330</b>	176	132
Operating expenses credit (expense)	<b>2</b>	19	(22 )
Impairment release (charge)	<b>-</b>	2	(2 )
<b>Underlying profit</b>	<b>332</b>	197	108

## **2016 COMPARED WITH 2015**

The underlying profit of £332 million was £135 million, or 69 per cent, higher than £197 million in 2015.

Total income increased by £154 million to £330 million in 2016 compared to £176 million in 2015 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 a credit of £2 million compared to a credit of £19 million in 2015.

## **2015 COMPARED WITH 2014**

Underlying profit was £197 million in 2015, £89 million higher than the £108 million profit in 2014.

Total income was £176 million, £44 million higher than 2014 as it included a full year benefit in net interest income from the exchange of the Enhanced Capital Notes in 2014.

Operating costs were a credit of £19 million compared with a charge of £22 million in 2014 and represent the residual amount after allocations to the divisions.

There was a net release of impairment of £2 million compared with a charge of £2 million in 2014.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2016			2015			2014		
	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	82,409	381	0.46	94,543	397	0.42	78,762	406	0.52
Loans and advances to customers	457,622	15,190	3.32	464,012	16,256	3.50	504,246	17,806	3.53
Debt securities	3,797	56	1.47	2,139	40	1.87	1,633	42	2.57
Available-for-sale financial assets	40,604	762	1.88	40,967	725	1.77	50,269	957	1.90
Held-to-maturity investments	16,003	231	1.44	13,256	197	1.49	–	–	–
Total interest-earning assets of banking book	600,435	16,620	2.77	614,917	17,615	2.86	634,910	19,211	3.03
Total interest-earning trading securities and other financial assets at fair value through profit or loss	81,961	1,594	1.94	87,583	1,955	2.23	82,018	1,993	2.43
<b>Total interest-earning assets</b>	<b>682,396</b>	<b>18,214</b>	<b>2.67</b>	<b>702,500</b>	<b>19,570</b>	<b>2.79</b>	<b>716,928</b>	<b>21,204</b>	<b>2.96</b>
Allowance for impairment losses on loans and receivables	(2,536 )			(4,729 )			(10,051 )		
Non-interest earning assets	148,965			145,224			158,584		
<b>Total average assets and interest income</b>	<b>828,825</b>	<b>18,214</b>	<b>2.20</b>	<b>842,995</b>	<b>19,570</b>	<b>2.32</b>	<b>865,461</b>	<b>21,204</b>	<b>2.45</b>

	2016			2015			2014		
	Average interest earning assets £m	Net interest income £m	Net interest margin %	Average interest earning assets £m	Net interest income £m	Net interest margin %	Average interest earning assets £m	Net interest income £m	Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	600,435	9,274	1.54	614,917	11,318	1.84	634,910	10,660	1.68
Trading securities and other financial assets at fair value through profit or loss	81,961	1,060	1.29	87,583	1,205	1.38	82,018	1,464	1.78
	<b>682,396</b>	<b>10,334</b>	<b>1.51</b>	<b>702,500</b>	<b>12,523</b>	<b>1.78</b>	<b>716,928</b>	<b>12,124</b>	<b>1.69</b>

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2016			2015			2014		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
<b>Liabilities and shareholders' funds</b>									
Deposits by banks	<b>10,540</b>	<b>68</b>	<b>0.65</b>	10,442	43	0.41	11,604	86	0.74
Customer deposits	<b>366,178</b>	<b>2,520</b>	<b>0.69</b>	380,137	3,299	0.87	416,651	4,781	1.15
Liabilities to banks and customers under sale and repurchase agreements	<b>8,342</b>	<b>38</b>	<b>0.46</b>	5,960	34	0.57	2,104	55	2.61
Debt securities in issue <sup>1</sup>	<b>85,030</b>	<b>799</b>	<b>0.94</b>	85,462	586	0.69	88,289	552	0.63
Amounts payable to unitholders in consolidated open-ended investment vehicles	<b>18,961</b>	<b>2,057</b>	<b>10.85</b>	21,059	244	1.16	18,620	602	3.23
Subordinated liabilities	<b>22,330</b>	<b>1,864</b>	<b>8.35</b>	24,975	2,091	8.37	29,332	2,475	8.44
Total interest-bearing liabilities of banking book	<b>511,381</b>	<b>7,346</b>	<b>1.44</b>	528,035	6,297	1.19	566,600	8,551	1.51
Total interest-bearing liabilities of trading book	<b>50,700</b>	<b>534</b>	<b>1.05</b>	61,560	750	1.22	54,980	529	0.96
<b>Total interest-bearing liabilities</b>	<b>562,081</b>	<b>7,880</b>	<b>1.40</b>	589,595	7,047	1.20	621,580	9,080	1.46
<b>Interest-free liabilities</b>									
Non-interest bearing customer accounts	<b>54,379</b>			45,294			42,049		
Other interest-free liabilities	<b>163,688</b>			158,852			157,824		
Non-controlling interests and shareholders' funds	<b>48,677</b>			49,254			44,008		
<b>Total average liabilities and interest expense</b>	<b>828,825</b>	<b>7,880</b>	<b>0.95</b>	842,995	7,047	0.84	865,461	9,080	1.05

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 2.70 per cent (2015: 2.76 per cent; 2014: 3.06 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.

## 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 2016 compared with 2015 and for 2015 compared with 2014.

Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2016 compared with 2015			2015 compared with 2014		
	Increase/(decrease)			Increase/(decrease)		
	Total change £m	Volume £m	Rate £m	Total change £m	Volume £m	Rate £m
<b>Interest receivable and similar income</b>						
Loans and receivables:						
Loans and advances to banks	(16 )	(56 )	40	(9 )	66	(75 )
Loans and advances to customers	(1,066)	(212 )	(854 )	(1,550)	(1,408 )	(142 )
Debt securities	16	24	(8 )	(2 )	9	(11 )
Available-for-sale financial assets	37	(7 )	44	(232 )	(165 )	(67 )
Held-to-maturity investments	34	–	34	197	–	197
Total banking book interest receivable and similar income	(995 )	(251 )	(744 )	(1,596)	(1,498 )	(98 )
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	(361 )	(109 )	(252 )	(38 )	124	(162 )
<b>Total interest receivable and similar income</b>	<b>(1,356)</b>	<b>(360 )</b>	<b>(996 )</b>	<b>(1,634)</b>	<b>(1,374 )</b>	<b>(260 )</b>
<b>Interest payable</b>						
Deposits by banks	25	1	24	(43 )	(5 )	(38 )
Customer deposits	(779 )	(96 )	(683 )	(1,481)	(318 )	(1,163)
Liabilities to banks and customers under sale and repurchase agreements	4	10	(6 )	(21 )	22	(43 )
Debt securities in issue	213	(4 )	217	34	(20 )	54
Amounts payable to unitholders in consolidated open-ended investment vehicles	1,813	(228 )	2,041	(358 )	28	(386 )
Subordinated liabilities	(227 )	(221 )	(6 )	(384 )	(365 )	(19 )
Total banking book interest payable	1,049	(538 )	1,587	(2,253)	(653 )	(1,600)
Total interest payable on trading and other liabilities at fair value through profit or loss	(216 )	(114 )	(102 )	221	80	141
<b>Total interest payable</b>	<b>833</b>	<b>(652 )</b>	<b>1,485</b>	<b>(2,032)</b>	<b>(573 )</b>	<b>(1,459)</b>

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **RISK OVERVIEW**

#### **EFFECTIVE RISK MANAGEMENT, GOVERNANCE AND CONTROL**

Managing risk effectively is fundamental to the Group's strategy and to operating successfully. The Group is a simple, low risk, UK focused, retail and commercial bank with a culture founded on a prudent through-the-economic-cycle appetite for risk.

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 approach their work, the way they behave and the decisions they make. Risk appetite – defined as the amount and type of risk that the Group is prepared to seek, accept or tolerate – is approved by the Board and is embedded within policies, authorities and limits across the Group.

#### **ACHIEVEMENTS IN 2016**

The Group has continued to deliver against its strategic priorities in 2016, simplifying and strengthening the business whilst growing in targeted areas. Risk has created a strong foundation to enable this progress, ensuring the Group reacts appropriately to the ever changing macro-economic and regulatory environment. The Group's prudent risk culture and appetite, along with close collaboration with the business, has enabled effective decision making and the achievement of a number of risk related deliverables in the year. These included:

##### **Conduct**

The Group's conduct strategy programme was fully implemented in 2016, embedding conduct into the everyday management of its business, ensuring that the Group retains a consistent and relentless focus on delivering improved customer outcomes through an open transparent culture.

##### **Capital strength**

The Group continues to maintain a strong capital position, with an adjusted CET1 ratio (taking account of the dividend paid by the insurance business in February 2017) of 13.7 per cent, through a combination of strong statutory profit driven by good underlying profit and lower PPI, along with lower risk-weighted assets. Risk-weighted assets reduced by 3 per cent to £215 billion, reflecting the continued de-risking of the portfolio, and were primarily driven by active portfolio management including asset sales, an improvement in asset quality and capital efficient securitisation activity.

The Group was also subject to the UK stress testing run by the Bank of England; passing on all levels, with no capital inadequacies identified.

### **Asset quality**

Effective risk management ensured asset quality remained strong with no deterioration in the underlying portfolio. The impairment charge increased to £645 million (2015: £568 million) with the asset quality ratio increasing slightly to 15 basis points, but this was largely due to lower provision releases and write-backs. The gross asset quality ratio remained unchanged at 28 basis points. The Group's prudent risk appetite and robust risk management framework were also reflected in impaired loans, which reduced by over £1 billion to £8.5 billion, and the impaired loans ratio, which continued to fall and is now below 2 per cent.

## **RISK GOVERNANCE**

The Board approves the Group's overall RMF and sets risk appetite, both of which are designed to ensure that the Group manages its risks in the right way to achieve its agreed strategic objectives. It has a dedicated Risk Committee of Non-Executive Directors who keep the design and performance of the Group's RMF under close and regular scrutiny and interact closely with the executive risk management committee operating at Group Executive

## **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.

Risks are identified, managed and mitigated using the Group's comprehensive Risk Management Framework (RMF), (see page 39) and its clearly defined risk appetite, embedded in policies, authorities and limits provides a clear framework for effective business decision making. The principal risks the Group faces, which could significantly impact the delivery of its strategy, are discussed on pages 40 to 43.

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

### **Prudent approach to risk**

Implementing a prudent approach to risk appetite across the Group, aligned to the embedding of a strong risk culture, driven both from the top and across the wider business, ensures the Group operates within risk appetite.

### **Strong control framework**

The Group's RMF acts as 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 individual business units are assessed. The business areas in the first line of defence are accountable for risk but with oversight from a strong and importantly independent, second line of defence Risk Division.

### **Effective risk analysis, management and reporting**

Continuing to deliver close monitoring and stringent reporting to all levels of management and the Board on a regular basis 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.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Committee level. The Board and senior management encourage a culture of transparency and openness to ensure that issues are escalated promptly to them where required.

The Board approved RMF and risk appetite are put into effect using an enterprise-wide framework which applies to every area of the business and covers all types of risk. The framework is designed to ensure the Group follows a consistent approach to risk management and reporting throughout, so that all risks are fully understood and managed in relation to its agreed risk appetite. It includes the Group's policies, procedures, controls and reporting.

A high level structure is shown in the diagram below.

The framework 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. This helps to ensure the Group continues to meet responsibilities to its customers, shareholders and regulators.

The Group's risk appetite and the policy framework define clear parameters within which its business units must operate in order to deliver the best outcome for customers and stakeholders. An updated risk appetite statement was approved by the Board in 2016.

The Board delegates authorities for risk management through the Group Chief Executive and the management hierarchy to individuals, an approach which is consistent with the focus of the Senior Managers and Certification Regime (SM&CR) on the principle of individual accountability. At a senior level, executives are supported in their decision making by a committee-based governance structure. The concept of individual accountability for risk management is embedded in the RMF and culture at every level, and guides the way all employees approach their work, behave and make decisions.

An important element of the framework is the maintenance of strong internal controls which are owned and operated by individual business areas. The Group's risk governance arrangements supported the effective implementation of the requirements of the SM&CR which came into force in 2016.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**THE MOST SIGNIFICANT RISKS WHICH COULD IMPACT THE DELIVERY OF THE GROUP'S LONG-TERM STRATEGIC OBJECTIVES AND RESPONSES, ARE DETAILED BELOW**

The Group has considered many of the potential implications following the UK's vote to leave the European Union and the impact to its customers, colleagues and products – as well as legal, regulatory, tax, finance and capital implications.

Continued uncertainty surrounding the political and macroeconomic environment remains but the potential impacts of external factors have been considered in all principal risks and uncertainties to ensure any material uncertainties continue to be monitored and are appropriately mitigated.

Principal risks and uncertainties are reviewed and reported regularly and no new risks have been identified in the year.

**PRINCIPAL RISKS KEY MITIGATING ACTIONS**

**CREDIT RISK**

The risk that customers and/or other counterparties whom the Group has either lent money to or entered into a financial contract with, or other counterparties with whom the Group has contracted, fail to meet their financial obligations, resulting in loss to the Group.

Adverse changes in the economic and market environment the Group operates in or the credit quality and/or behaviour of its customers and counterparties could reduce the value of the Group's assets and potentially increase its write downs and allowances for impairment losses, adversely impacting profitability.

**Example:**

Whilst the Group has a deep understanding of credit risks across its commercial, mortgage and other portfolios; a changing economic environment, e.g. interest rate rises, can impact on customer affordability and therefore the Group's performance.

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 lend 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.

## **REGULATORY AND LEGAL RISK**

The risks of changing legislation, regulation, policies, voluntary codes of practice and their interpretation in the markets in which the Group operates can 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.

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

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

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

## **CONDUCT RISK**

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; and exhibiting behaviours which do not meet market or regulatory standards.

### **Example:**

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

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

-Product approval, review processes and outcome testing 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.

-The development of a refined framework for addressing thematic issues impacting customers in vulnerable circumstances.

## **OPERATIONAL RISK**

The Group faces significant operational risks which may result in financial loss, disruption of services to customers, and damage to the Group's reputation. These include the availability, resilience and security of core IT systems and the potential for failings in customer processes.

### **Examples:**

-A resilient IT environment is critical to providing reliable services to customers and enabling sustainable growth.

-The dynamic threat posed by cyber risk on the integrity of electronic data or the availability of systems.

-Continual review of the Group's IT environment to ensure that systems and processes can effectively support customers' requirements.

-Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis.

-Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems and responding to findings from third party industry testing.

## **PEOPLE RISK**

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

**Example:**

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

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 customers' needs.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**KEY RISK  
INDICATORS**

**ALIGNMENT TO STRATEGIC PRIORITIES AND FUTURE FOCUS**

**Delivering sustainable growth**

**Read more on page 53**

Impairment charge

The Group has a conservative and well balanced UK credit portfolio, managed through the economic cycle and supported by strong credit portfolio management.

Impaired assets

Credit risk decisions are consistent, fair and responsible, taking account of customers' circumstances. The Group supports sustainable growth and meeting targets in the Helping Britain Prosper Plan while staying within prudent risk appetite.

Impairments remain below long term levels and are expected to increase as the level of write-backs and releases normalise. Emerging credit risks that have the potential to increase impairment include the global and UK economic environment, in particular increasing interest rates, as it can impact customer and counterparties' affordability.

**Delivering sustainable growth**

**Read more on page 108**

Mandatory, legal and regulatory investment spend

The Group is committed to operating sustainably and responsibly, and commit significant resource and expense to ensure the Group meets its legal and regulatory obligations.

The Group responds as appropriate to impending legislation and 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.

**Creating the best customer experience**

Conduct risk appetite  
metric  
performance-Group

**Read more on page 86**

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

The successful transition of the Group's customer-focused Conduct Strategy into Business as Usual, following robust review by the Group Customer First Committee, supports the Group's vision of being the best bank for customers, enabling the creation of the best customer experience through learning from past mistakes.

**Creating the best customer experience**

**Read more on page 93**

Availability of core  
systems

The Group recognises that resilient and secure technology is critical to creating the best 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. The control environment is regularly assessed through internal and third party testing.

**Creating the best customer experience**

Best bank for customers  
index **Read more on page 110**

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 changing customer needs. The Group continues to focus on developing colleagues, their capabilities and skills in order to create the best 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

**PRINCIPAL RISKS KEY MITIGATING ACTIONS**

**INSURANCE RISK**

Key insurance 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. Longevity is also the key insurance risk in the Group's Defined Benefit Pension Schemes.

**Examples:**

– Increases in life expectancy (longevity) beyond current assumptions will increase the cost of annuities and pension scheme benefits.

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

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 both the Insurance business and the Group's Defined Benefit Pension Schemes.

Property insurance exposures are mitigated by a broad reinsurance programme.

**CAPITAL RISK**

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.

A comprehensive capital management framework that sets and monitors capital risk appetite, including dividend policy appropriately.

Close monitoring of capital and leverage ratios to ensure the Group meets current and future regulatory requirements.

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



## FUNDING AND LIQUIDITY RISK

The risk that the Group has insufficient financial resources to meet commitments as they fall due, or can only secure them at excessive cost.

### Example:

The Group's funding and liquidity position is underpinned by a significant and stable customer deposit base and is supported by strong relationships with corporate customers and certain wholesale market segments. 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.

— Holding liquid assets to meet potential cash and collateral outflows, regulatory requirements and maintaining a further pool of secondary 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.

## GOVERNANCE RISK

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from the requirement to improve the resolvability of the Group and to ring-fence core UK financial services and activities from January 2019 and further requirements under the SM&CR which come into force from March 2017.

### Example:

— Non-compliance with or breaches of ring-fencing, resolution and SM&CR requirements will result in legal and regulatory consequences.

— Leveraging the Group's considerable change experience to meet ring-fencing and resolution planning requirements and the continuing evolution of SM&CR.

— Programme in place to address ring-fencing and resolution planning. In close and regular contact with regulators to develop plans for the Group's anticipated operating and legal structure.

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

## MARKET RISK

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 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 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. Credit spreads affect the value of the Group's Defined Benefit Pension Schemes' liabilities.

Structural hedge programmes implemented to manage liability margins and margin compression, and the Group's exposure to Bank Base Rate.

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

The Group's Defined Benefit Pension Schemes have increased their credit allocation and hedged against nominal rate/inflation movements.

Stress and scenario testing of Group risk exposures.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**KEY RISK INDICATORS ALIGNMENT TO STRATEGIC PRIORITIES AND FUTURE FOCUS**

**Creating the best customer experience**

Insurance (Life and Pensions)  
present value of new business  
premiums

**Read more on page 109**

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 creating the best customer experience by helping customers protect themselves today whilst preparing for a secure financial future.

Insurance (General Insurance)  
gross written premiums

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

**Delivering sustainable growth**

**Read more on page 101**

Common equity tier 1 ratio<sup>1,2</sup>

Ensuring the Group holds an appropriate level of capital to maintain financial resilience and market confidence, underpins its strategic objectives of supporting the UK economy and delivering sustainable growth.

Leverage ratio<sup>2</sup>

Looking ahead, there are a number of regulatory capital framework changes which are yet to be finalised. These changes are being monitored closely as there is a risk that these could lead to higher capital requirements in the longer term.

Regulatory liquidity

**Delivering sustainable growth**

**Read more on page 95**

Loan to deposit ratio

The Group maintains a strong funding position in line with its low risk strategy. The Group's funding position has been significantly strengthened in recent years and the loan to deposit ratio remains within its target range.

Liquid assets now exceed the Group's total wholesale funding. This provides a substantial buffer in the event of a market-wide stress which could reduce options to fund the Group's balance sheet in future.

### **Delivering sustainable growth**

#### **Read more on page 111**

N/A

Ring-fencing will ensure the Group becomes safer and continues to create the best 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.

Resolution planning is intended to reduce the probability of failure and, through ensuring continuity of critical banking services, the impact on customers should the Group fail.

The Group's Governance framework and strong culture of ownership and accountability enabled effective, on time, compliance with the SM&CR requirements which came into force from March 2016 and preparation for the SM&CR Certification requirements effective from March 2017.

Pension surplus/(deficit)

### **Delivering sustainable growth**

#### **Read more on page 87**

The Group manages exposure to movements in market rates throughout the year, leading the Group to promote low volatility earnings and offer a comprehensive customer proposition with market risk hedging strategies to support strategic aims, including delivering sustainable growth.

Mitigating actions are implemented to reduce the impact of market movements, resulting in a more stable capital position. This allows the Group to more efficiently

utilise available capital resources to deliver sustainable growth.

Consistent with similar pension schemes, the Group's Defined Benefit Pension Schemes were adversely impacted by the credit spread volatility in the third quarter of 2016. The interest rate and inflation hedging programmes remain effective.

<sup>1</sup> This key risk indicator is also a key performance indicator (KPI).

The CET1 and leverage ratios at 31 December 2016 and 31 December 2015 are reported on an adjusted basis, <sup>2</sup>including dividends paid by the Insurance business in February 2017 and February 2016 respectively, in relation to prior year earnings.

43

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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. 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 38 to 43) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, risk achievements in 2016 along with a brief overview of the Group's risk governance structure 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 44 to 51) and a full analysis of the primary risk drivers (pages 52 to 112) – the framework by which risks are identified, managed, mitigated and monitored.

Each risk driver 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 Board Risk Appetite and through good risk reward decision making.

**Risk culture**

The Board ensures that senior management implements risk policies and risk appetites 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 Codes of Business and Personal Responsibility in 2016 reinforcing its approach where colleagues are accountable for the risks they take and where the needs of customers are paramount.

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 Board Risk Appetite Statement which is reviewed by the Board Risk Committee and approved annually by the Board.

The Board metrics are supported by more detailed sub-Board functional and divisional risk appetite metrics.

The Board Risk Appetite is aligned to the Risk Appetite Framework, and in turn the Risk Management Framework and Group Risk Principles.

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 Board Risk Appetite and business planning is undertaken with a view to meeting the requirements of the Board 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 and its risk appetite, to ensure they are in line with emerging regulatory, corporate governance and industry best practice.

Board Risk Appetite includes the following areas:

Credit – the Group has a conservative and well balanced credit portfolio through the economic cycle.

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

Market – the Group takes minimal proprietary trading risk, 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. It identifies and assesses emerging risks and acts to mitigate these.

Funding and liquidity – the Group maintains a prudent liquidity profile to ensure it can survive under stressed conditions, and a balance sheet structure that limits its reliance on potentially volatile sources of funding.

Capital and earnings – the Group maintains capital levels commensurate with a prudent level of solvency, even under stressed conditions. It aims to deliver consistent and high quality earnings and has low appetite for earnings shocks or surprises from any risk type.

Regulatory and legal – the Group complies with all relevant regulation and all applicable laws (including Codes of Practice which could 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.

Financial reporting – the Group meets regulatory reporting and tax requirements in jurisdictions where it operates and ensures the timely and transparent disclosure and dissemination of information relating to its listed debt or equity.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

As a separate regulated entity with its own Board, the Insurance business has its own Risk Appetite and maintains its own Risk Appetite framework, 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.

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 management is directly accountable for identifying and managing risks in their individual businesses, ensuring that business decisions strike an appropriate balance between risk and reward 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.

## 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 (BRC) of the aggregate risk profile and as a member of the Board, has direct access to the Chairman and members of BRC.

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 in its risk measures and balance sheet. Details of the business activities for each division are provided in the Divisional Results on pages 28 to 34.

	Retail £bn	Commercial Banking £bn	Consumer Finance £bn	Run-off £bn	Central Items <sup>1</sup> £bn	Insurance <sup>2</sup> £bn	Group £bn
<b>Risk-weighted assets (RWAs)</b>							
– Credit risk	39.7	78.2	28.6	8.3	11.9	–	166.7
– Counterparty credit risk	–	8.6	–	–	1.0	–	9.6
– Market risk	–	3.1	–	–	–	–	3.1
– Operational risk	15.5	6.1	3.5	0.2	–	–	25.3
<b>Total (excluding threshold)</b>	<b>55.2</b>	<b>96.0</b>	<b>32.1</b>	<b>8.5</b>	<b>12.9</b>	<b>–</b>	<b>204.7</b>
– Threshold	–	–	–	–	10.7	–	10.7
<b>Total</b>	<b>55.2</b>	<b>96.0</b>	<b>32.1</b>	<b>8.5</b>	<b>23.6</b>	<b>–</b>	<b>215.4</b>

<sup>1</sup> Central Items include assets held outside the main operating divisions, including exposures relating to Group Corporate Treasury which holds the Group's liquidity portfolio, and Group Operations.

As a separate regulated business, Insurance 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, part of the Group's investment in Insurance is included in the calculation of Threshold RWAs, subject to CRD IV rules, while the remainder is taken as a capital deduction.

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

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

**PRINCIPAL RISKS**

The Group's principal risks are shown in the risk overview (pages 40 to 43). The Group's emerging risks are shown overleaf. Full analysis of the Group's risk drivers is on pages 52 to 112.

45

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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**

**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.

**Macroeconomic headwinds and political uncertainties:** Political uncertainties over the UK's relationship with EU Countries remains with US election outcomes and European elections adding to a globally uncertain political and macroeconomic outlook.

**Key mitigating actions**

– The Group continues to embed the strategic conduct agenda across all areas ensuring that the customer is at the heart of the Group's business planning, whilst working closely with regulatory authorities and industry bodies to ensure that the Group can identify and respond to the evolving regulatory and legal landscape.

– Programmes in place to deliver regulatory and legal change requirements.

– Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts.

– 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/regulatory requirements.

– Continued delivery of cyber control framework and investment in Cyber programme.

**IT resilience and cyber:** Increasing digitisation places greater reliance on the provision of resilient and secure services to customers. Potential increases in the volume of cyber-attacks could disrupt service for customers, causing financial loss/reputational damage.

– Operational Resilience activities will be combined with currency upgrades to form a new Technology Resilience programme.

– Organisational and behavioural effectiveness is regularly reviewed, ensuring simplicity/efficiency, supporting the Group's strategy.

**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.

– Sustained and continuing investment in digital capability and customer channels; plans updated to reflect market trends/customer behaviour.

– Assessment of the possible impacts of legislation is ongoing; delivery of enhanced systems and processes to fulfil related regulatory requirements.

**Strategic use of customer data:** Impacts of Data Regulation in respect of data sharing, data privacy and data loss, noting the need to defend against dynamic external challengers and consumer expectations. Failure to address growth in data movement or understand the Supply Chain/Third party controls may increase exposure to Cyber/Fraud leading to conduct/reputational issues.

– Chief Data Officer reviewing operating model and identifying opportunities to enhance the associated control environment.

– Updates reported to Board and GEC on key components of non ring-fence programmes.

**Ring-fencing:** Legislation and rules impact the business and operating model and cost of serving customers effectively. EU Exit/ heightened implementation risk may require a change to target business/ operational model adding complexity, timescales and execution costs.

– The Group is actively engaged with HM Treasury, the PRA and FCA to ensure that it is able to fully implement the restructuring required to implement ring-fencing by the January 2019 deadline.

**Resolution:** Plans are in place to deliver on bail-in-able debt (MREL) for the Group by 1 January 2022 (interim target 1 January 2020); uncertainty surrounds investor appetite/pricing as many banks will approach the same investor base over a similar period.

– Early engagement with investors; capitalising on the Group's name in the market, and spread issuance over the time window available.

– Risk appetite criteria limits single counterparty bank/non-bank exposures complemented by a UK-focused strategy.

**Geopolitical shocks:** Current uncertainties could further impede the global economic recovery. Events in China, Russia, the Middle-East, as well as terrorist activity, have the potential to worsen economic outlook and funding conditions.

– Financial Stability Forum develops and maintains Stability Response Plan; acting as a Rapid Reaction Group, when external crises occur.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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 PRA and management buffers (see Capital Risk on pages 101 to 108).

**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**

During 2016, the Group was subject to the European Banking Authority's Europe-wide stress test with the Group's results significantly above minimum capital requirements. The concurrent UK stress test run by the Bank of England was also undertaken in 2016. As announced in November, the Group comfortably exceeded the capital thresholds set by the Prudential Regulation Authority and was not required to take any action as a result of this test.

## **INTERNAL STRESS TESTS**

At least on an annual basis, the Group conducts macroeconomic stress tests of the operating plan, which is 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 principal risks on pages 52 to 112 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 Risk and Finance areas is built into the preparation process, so that the appropriate analysis of each risk driver'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 Director's, appropriate Risk Director's and Managing Director's 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 review and challenge, before being approved by the Board.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### HOW RISK IS MANAGED IN LLOYDS BANKING GROUP

The Group's Risk Management Framework (RMF) (see risk overview, page 38) is structured around the following nine 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 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 over risk management consistent with the 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 page 44).

### 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.

The risk committee governance framework is outlined below.

**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 providing 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.

Group Audit (third line) provides independent and objective assurance designed to add value and improve the organisation’s operations. It helps the Group accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. Group Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Audit is fully independent of the business and the Risk Division, and seeks to ensure objective challenge to the effectiveness of the risk governance framework.

**Mandate of the Risk Division** – the objective of Risk Division is to provide both proactive advice and constructive challenge to the business. 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.

Risk Division, headed by the Chief Risk Officer, consists of eight Risk Directors and their specialist teams. These teams provide oversight and independent challenge to business management and support senior management and the Board with independent reporting on risks and opportunities. Risk Directors, responsible for each risk type, meet on a regular basis under the chairmanship of the Chief Risk Officer to review and challenge the risk profile of the Group and to ensure that mitigating actions are appropriate.

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.

48

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

–propose risk appetite and oversight of the associated risk profile across the Group.

**Risk identification, measurement and control** – 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 in comprehensive risk logs/ registers, 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.

**Risk monitoring, aggregation and reporting** – identified risks are logged and 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 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 GEC and Board. Conversely, strategic direction and guidance is cascaded down from the Board and GEC.

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**

<b>GROUP CHIEF EXECUTIVE COMMITTEES</b>	<b>BUSINESS AREA PRINCIPAL ENTERPRISE RISK COMMITTEES</b>	<b>RISK DIVISION COMMITTEES AND GOVERNANCE</b>
<b>Group Executive Committee (GEC)</b>	<b>Retail Risk Committee</b>	<b>Credit Risk</b>
<b>Group Risk Committee (GRC)</b>	<b>Consumer Finance Risk Committee</b>	– Executive Credit Approval Committee
<b>Group Asset and Liability Committee (GALCO)</b>	<b>Customer Products and Markets Risk Committee</b>	– Commercial Banking Credit Risk Committees – Retail & Consumer Credit Risk Committees
<b>Group Customer First Committee</b>	<b>Commercial Banking Risk Committee</b>	<b>Market Risk</b>
<b>Group Cost Management Committee</b>	<b>Digital Risk Committee</b>	– Group Market Risk Committee

**Conduct Review  
Committee**

**Insurance Risk Committee**

**Executive Compensation  
Committee**

**Finance Risk Committee**

**Conduct, Compliance and Operational Risk**

**Responsible Business  
Management Committee**

**Group Operations Risk  
Committee**

– Group Conduct, Compliance & Operational Risk  
Committee

**Group Functions Executive/Risk  
Committees**

**Risk Division Risk Committee**

**Fraud and Financial Crime Risk**

– Group Financial Crime Prevention Committee

– Group Fraud Committee

**Financial Risk**

– Group Financial Risk Committee

**Capital Risk**

– Group Capital Risk Committee

**Model Risk**

– Group Model Governance Committee

**Insurance 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 152 to 176, for further information on Board committees.

The divisional/functional risk committees review and recommend divisional/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:

<b>Committees</b>	<b>Risk focus</b>
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, material Group policies and the allocation of risk appetite. The committee also regularly reviews risk exposures and risk/reward returns and approves material risk models.
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 (GCFC)	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 set and promote the appropriate tone from the top to fulfil the Group’s vision to

## Edgar Filing: Lloyds Banking Group plc - Form 20-F

	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 Executive	Provides oversight and challenge in connection with the Group's engagement with conduct review matters as agreed with the Group Chief Executive.
Compensation Committee	Provides governance and oversight for Group-wide remuneration matters and policies.
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.
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 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 (GMRC)	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.
Group Financial Crime Prevention Committee	Reviews and challenges the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.
Group Fraud Committee	Is responsible for ensuring that the development and application of fraud risk management complies with the Group's strategic aims and risk appetite, and broader corporate responsibilities. The committee provides direction and focus to priorities which enhance the Group's fraud risk management capabilities in line with business and customer objectives, including engagement with external fraud detection and prevention bodies.
Group Financial Risk Committee	Responsible for reviewing, challenging and recommending to GEC/GRC/GALCO, the Group Individual Liquidity Adequacy Assessment and Internal Capital Adequacy Assessment Process (ICAAP) submissions, the Group Recovery Plan, and the annual stress testing of the Group's operating plan, PRA and EBA stress tests, and any other analysis as required.
Group Capital Risk Committee	Provides oversight of capital matters within the Group including the Group's capital position, Pillar 2 requirements, regulatory reform and accounting developments specific to capital, and reviews regulatory submissions including the ICAAP and Recovery Plan prior to submission to GFRC.
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 risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than material models which are approved by GRC.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**FULL ANALYSIS OF RISK DRIVERS**

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 below.

**PRIMARY RISK DRIVERS**

<b>Credit risk</b>	<b>Conduct risk</b>	<b>Market risk</b>	<b>Operational risk</b>	<b>Funding and liquidity risk</b>	<b>Capital risk</b>	<b>Regulatory and legal risk</b>	<b>Insurance risk</b>	<b>People risk</b>	<b>Financial reporting risk</b>
Page 53	Page 86	Page 87	Page 93	Page 95	Page 101	Page 108	Page 109	Page 110	Page 111

**SECONDARY RISK DRIVERS**

Portfolio concentration risk	Customer risk	Interest rate risk	Regulatory and legal process	Funding risk	Capital sufficiency	Compliance risk	Longevity risk	Resourcing and performance	Financial and prudential regulatory reporting
Counterparty credit risk	Product risk	Equity risk	Client money/fiduciary obligations	Liquidity risk	Capital efficiency	Competition risk	Mortality risk	Culture and engagement	Tax reporting and compliance
Country risk	Product distribution/advice risk	Foreign exchange risk	Conduct process			Legal risk	Morbidity risk	Talent and succession	Pillar 3 disclosure
Collateral management risk		Credit spread risk	Financial crime				Customer behaviour risk (including persistency risk)	Learning and Well-being	
		Inflation risk	Fraud					Legal and regulatory (people)	
		Property risk	Sourcing				Property insurance risk		
		Alternative asset risk	Internal service provision						
		Basis risk	External service provision				Expenses risk		

Commodity(divested clients)  
risk

Physical security  
and health and  
safety

Information  
security and  
cyber

IT systems

Change

Business process

Financial  
reporting process

Governance  
process

Risk process

Operational  
resilience

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 driver.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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 or 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 52 on page F-87. Credit risk exposures are categorised as 'retail', arising primarily in the Retail, Consumer Finance 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 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 2016 is shown on page 61. 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 52 on page F-87.

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 Division largely result from holding bond and loan assets 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 36 on page F-47 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, or because the terms required to refinance are outside acceptable appetite at the time. 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 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' 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').

For regulatory capital purposes the Group's rating systems assess probability of default and if appropriate, exposure at default and loss given default, in order to derive Risk Weighted Assets (RWAs) and regulatory Expected Loss (EL). If not appropriate, regulatory prescribed exposure at default and loss given default values are used in order to derive RWAs and EL.

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 expected loss models. Note 2(H) on page F-13 provides details of the Group's approach to the impairment of financial assets.

The obligor quality measurement of both retail and commercial counterparties is largely based on the outcomes of credit risk (probability of default PD) 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 in model development, 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/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 probability of default 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.

## 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, risk policies and risk appetite statements. Principles and policies are reviewed regularly, and any changes are subject to a review and approval process. Policies and risk appetite statements, where appropriate, are supported by procedures, which provide a disciplined and focused benchmark for credit

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 key appetite tolerances. Oversight and reviews are also undertaken by Credit Risk Oversight and Group Audit.

**Strong rating systems and controls:** The Group has established an independent team in the Risk Division that sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating models are developed and owned by the Risk Division. The designated model owner takes responsibility for ensuring the validation of the rating systems, supported and challenged by an independent specialist Group function.

**Limitations on concentration risk:** Credit risk management includes 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 more vulnerable sectors and asset classes. Note 18 on page F-33 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 large exposures are detailed to the Board and reported in accordance with regulatory reporting requirements.

**Robust country risk management:** The Board sets country risk appetite. Within this, country limits are authorised by the Group Country Risk Appetite Committee, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support, the approved business and strategic plans of the Group.

**Specialist expertise:** Credit quality is managed and controlled by a number of specialist units within Risk Division providing, for example: intensive management and control (see 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 the stress testing process, methodology and governance refer to page 47.



**Frequent and robust credit risk oversight and assurance:** Undertaken by independent Credit Risk Oversight functions operating within Retail and Consumer 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 Audit performs the third line of credit risk assurance. A specialist team within Group Audit, comprising experienced credit professionals, is in place to carry out independent risk based internal control audits, providing an assessment of the effectiveness of internal credit controls, across the full credit lifecycle including the raising of impairment provisions. These audits cover the diverse range of the Group's businesses and activities, and include both 'standard' risk based audits and reviews as well as agreed upon procedures to respond to any emerging risks or regulatory requirement. The work of Group Audit therefore continues to provide executive, senior management and Board Audit Committee with assurance on effectiveness of credit risk controls, as well as appropriateness of impairments.

#### **ADDITIONAL MITIGATION FOR RETAIL AND CONSUMER FINANCE 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 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. Loans above £500,000 are subject to a range of further controls, including reduced maximum income multiples, and increased case review via manual underwriting.

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.

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 limits:** Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements 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 for loans and advances, contingent liabilities and derivatives with commercial and bank counterparties/customers are:

- properties;
- charges over business assets such as premises, inventory and accounts receivables;
- financial instruments such as debt securities;
- 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, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex (CSA) in conjunction with the ISDA Master Agreement. Derivative transactions with non-bank 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/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 always 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 loan to value 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 residential mortgages, the Group adjusts open market property 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 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 52 for further information on collateral.

## **MASTER NETTING AGREEMENTS**

It is credit policy that a Group approved Master Netting Agreement must be used for all 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **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 seek to ensure that models provide appropriate risk differentiation capability, the generated ratings remain as accurate and robust as practical, and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that 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 AND CONSUMER FINANCE 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 residential 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 and Consumer Finance 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 classifies the balance as forborne for a period of 24 months, after which no distinction is made between these accounts and others where no change has been made.

Those forborne loans which fall below individual assessment limits are grouped with other assets of similar characteristics and assessed collectively for impairment in accordance with the Group impairment policy detailed in note 2(H). 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 per cent of customers accepting reduced payment arrangements are performing. For permanent treatments, 83 per cent of customers who have accepted capitalisations of arrears and 84 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 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:

Unemployed customers claiming Jobseekers Allowance: Qualifying customers are able to claim for mortgage interest at 3.12 per cent on up to £200,000 of the mortgage. There is a two year time limit on claims.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Pension Credit customers: Qualifying customers are able to claim for mortgage interest at 3.12 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 £1.8 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.

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 Business Support Unit (BSU) at an early stage. 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 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) and 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 Division BSU gross lending to customers reduced from £4.2 billion to £3.4 billion between 31 December 2015 and 31 December 2016. 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 page 24).

## **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 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 Lloyds Bank Commercial Finance Ltd and The Agricultural Mortgage Corporation Plc.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **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/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 as having been (or will be) granted some form of forbearance. Most impaired loans and advances exist only in the BSU within Commercial Banking Division and Run-off Division.

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**

A customer where forbearance has been granted will remain treated and recorded as forborne until it evidences acceptable performance over a period of time. This period will depend on a number of factors such as whether the customer is trading in line with its revised plan, it is operating within the new terms and conditions (including observation to revised covenants and contractual payments), its financial performance is stable or improving and there are no undue concerns over its future performance. As a minimum, this 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 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 back to within a covenant). In this case, the customer may exit forbearance once the permanent cure has been made.

However, 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 2016

### Overview

Asset quality remains strong with portfolios continuing to benefit from the Group's pro-active approach to risk management, continued low interest rates and a resilient UK economic environment.

The impairment charge increased by 14 per cent to £645 million in 2016 compared to £568 million in 2015. Gross charges remained broadly flat with the increase in net charges largely due to lower levels of releases and write-backs.

The asset quality ratio for 2016 was 15 basis points compared to 14 basis points during 2015 and the gross asset quality ratio (excluding releases and write-backs) was stable at 28 basis points.

Looking forward the 2017 full year asset quality ratio is expected to increase to around 25 basis points primarily reflecting lower releases and write-backs.

58

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Impaired loans as a percentage of closing loans and advances reduced to 1.8 per cent at 31 December 2016, from 2.1 per cent at 31 December 2015, with impaired loans reducing by £1,095 million to £8,495 million during the period, due to further reductions in the Commercial Banking, Consumer Finance and Run-off portfolios.

### **Low risk culture and prudent risk appetite**

The Group continues to operate a prudent approach to credit risk, with the portfolios benefiting from the focus on credit at origination and a prudent through the cycle approach to credit risk appetite. The Group's portfolios are well positioned against current economic concerns and market volatility.

The Group's credit processes and controls ensure effective risk management, including early identification and management of customers and counterparties who may be showing signs of distress.

The Group has delivered lending growth in key segments without relaxing credit criteria despite terms and conditions in some of the Group's markets being impacted by increased competition and, in Commercial Banking, uncertainty in some sectors.

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 Retail UK Secured portfolio at 31 December 2016 was 44.0 per cent (31 December 2015: 46.1 per cent). The percentage of closing loans and advances with an indexed LTV greater than 100 per cent was 0.7 per cent (31 December 2015: 1.1 per cent).

Total UK Direct Real Estate gross lending across the Group was £19.9 billion (31 December 2015: £19.7 billion). This mainly includes Commercial Banking lending of £18.5 billion, £0.5 billion booked in the Islands Commercial business and £0.2 billion within Retail Business Banking (within Retail Division) with the Group continuing to write new business within conservative risk appetite parameters. The Group's significantly reduced legacy run-off direct real estate portfolio has continued to fall to £0.7 billion at 31 December 2016 (31 December 2015: £1.1 billion), and now represents a very modest element of the total UK Direct Real Estate lending portfolio.

Run-off net external assets stood at £11,336 million at 31 December 2016, down from £12,154 million at 31 December 2015. The portfolio represents only 2.1 per cent of the overall Group's loans and advances (31 December 2015: 2.3 per cent).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.4: Group impairment charge

2016	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	2015 <sup>1</sup> £m
Retail	373	–	–	–	373	349
Commercial Banking	21	–	–	(5)	16	(22)
Consumer Finance	282	–	–	–	282	235
Run-off	(17)	–	–	(9)	(26)	8
Central items	(2)	–	–	2	–	(2)
Total impairment charge	657	–	–	(12)	645	568
Asset quality ratio					0.15%	0.14%
Gross asset quality ratio					0.28%	0.28%

<sup>1</sup> Restated.

Table 1.5: Movement in gross impaired loans

	2016					2015
	Retail £m	Commercial Banking £m	Consumer Finance £m	Run-off £m	Total £m	Total £m
At 1 January <sup>1</sup>	4,112	2,543	910	2,025	9,590	14,308
Classified as impaired during the year	1,947	671	425	111	3,154	3,401
Transferred to not impaired during the year	(800)	(112)	(81)	(54)	(1,047)	(1,358)
Repayments	(517)	(595)	(121)	(94)	(1,327)	(1,729)
Amounts written off	(391)	(311)	(285)	(485)	(1,472)	(1,503)
Impact of disposal of business and asset sales	–	(33)	(49)	(410)	(492)	(3,403)
Exchange and other movements	3	16	(54)	124	89	(126)
<b>At 31 December</b>	<b>4,354</b>	<b>2,179</b>	<b>745</b>	<b>1,217</b>	<b>8,495</b>	<b>9,590</b>

<sup>1</sup> Restated.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.6: Group impaired loans and provisions

	Loans and advances to customers £m	Impaired Loans £m	Impaired loans as % of closing advances %	Impairment provisions <sup>1</sup> £m	Provision as % of impaired loans <sup>2</sup> %
<b>At 31 December 2016</b>					
Retail	299,493	4,354	1.5	1,630	38.2
Commercial Banking	101,176	2,179	2.2	824	37.8
Consumer Finance	35,494	745	2.1	396	85.0
Run-off	10,259	1,217	11.9	682	56.0
Reverse repos and other items <sup>3</sup>	15,249				
<b>Total gross lending</b>	<b>461,671</b>	<b>8,495</b>	<b>1.8</b>	<b>3,532</b>	<b>43.4</b>
Impairment provisions	(3,532)	)			
Fair value adjustments <sup>4</sup>	(181)	)			
<b>Total Group</b>	<b>457,958</b>				
<b>At 31 December 2015<sup>5</sup></b>					
Retail	307,500	4,112	1.3	1,564	39.2
Commercial Banking	103,082	2,543	2.5	1,091	42.9
Consumer Finance	31,827	910	2.9	367	75.5
Run-off	11,422	2,025	17.7	1,150	56.8
Reverse repos and other items <sup>3</sup>	5,798				
Total gross lending	459,629	9,590	2.1	4,172	46.1
Impairment provisions	(4,172)	)			
Fair value adjustments <sup>4</sup>	(282)	)			
Total Group	455,175				

<sup>1</sup> Impairment provisions include collective unidentified impairment provisions.

Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries in Retail (31 December 2016: £86 million; 31 December 2015: £118 million) and in Consumer Finance (31 December 2016: £279 million; 31 December 2015: £424 million).

<sup>3</sup> Includes £6.7 billion (December 2015: £5.7 billion) of lower risk loans sold by Commercial Banking and Retail to Insurance to back annuitant liabilities.

The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group's consolidated financial records at their fair value and took into account both the expected losses and market liquidity at the date of acquisition. The fair value unwind in respect of impairment losses incurred was £70 million for the year ended 31 December 2016 (31 December 2015: £97 million). The fair value unwind in respect of loans and advances is expected to continue to decrease in future years and will reduce to zero over time.

<sup>5</sup> Restated.

Table 1.7: Derivative credit risk exposures

	2016				2015			
	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	–	254	369,368	369,622	6,568	–	383,722	390,290
Interest rate	167,399	3,023,742	423,709	3,614,850	31,128	3,598,307	791,351	4,420,786
Equity and other	32,172	–	11,046	43,218	4,837	–	9,337	14,174
Credit	–	–	8,098	8,098	–	–	4,566	4,566
<b>Total</b>	<b>199,571</b>	<b>3,023,996</b>	<b>812,221</b>	<b>4,035,788</b>	<b>42,533</b>	<b>3,598,307</b>	<b>1,188,976</b>	<b>4,829,816</b>
Fair values								
Assets		262	35,563			103	28,811	
Liabilities		(1	) (34,506	)		(131	) (26,149	)
<b>Net asset</b>		<b>261</b>	<b>1,057</b>			<b>(28</b>	<b>) 2,662</b>	

The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2016 and 31 December 2015 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 52 on page F-87.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**Retail**

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

The impairment charge increased by £24 million to £373 million for 2016, an increase of 7 per cent compared to 2015.

The Overdrafts impairment charge increased by £12 million to £241 million, driven by a change to collections entry criteria.

The Secured impairment charge increased by £6 million to £104 million, reflecting a continued prudent approach to provisioning.

The Retail Business Banking impairment charge increased by £6 million to £27 million, following a revised modelling approach and an increase in lending balances.

Impairment provisions as a percentage of impaired loans decreased to 38.2 per cent from 39.2 per cent at the end of 2015.

Table 1.8: **Retail impairment charge**

	<b>2016</b>	2015 <sup>1</sup>	Change
	<b>£m</b>	£m	%
Secured	<b>104</b>	98	(6 )
Overdrafts	<b>241</b>	229	(5 )
Wealth	<b>1</b>	1	—
Retail Business Banking	<b>27</b>	21	(29 )
<b>Total impairment charge</b>	<b>373</b>	349	(7 )
Asset quality ratio	<b>0.12%</b>	0.11%	1bp

1. Restated.

Table 1.9: **Retail impaired loans and provisions**

Loans and advances to customers	Impaired loans £m	Impaired loans as a % of closing	Impairment provisions <sup>1</sup> £m	Impairment provisions as a % of impaired
---------------------------------	-------------------	----------------------------------	---------------------------------------	--

Edgar Filing: Lloyds Banking Group plc - Form 20-F

	£m		advances %		loans <sup>2</sup> %
<b>At 31 December 2016</b>					
Secured	<b>294,503</b>	<b>4,104</b>	<b>1.4</b>	<b>1,503</b>	<b>36.6</b>
Overdrafts	<b>1,952</b>	<b>179</b>	<b>9.2</b>	<b>90</b>	<b>82.6</b>
Wealth	<b>2,034</b>	<b>44</b>	<b>2.2</b>	<b>15</b>	<b>34.1</b>
Retail Business Banking	<b>1,004</b>	<b>27</b>	<b>2.7</b>	<b>22</b>	<b>200.0</b>
<b>Total gross lending</b>	<b>299,493</b>	<b>4,354</b>	<b>1.5</b>	<b>1,630</b>	<b>38.2</b>
Impairment provisions	<b>(1,630 )</b>				
Fair value adjustments	<b>(181 )</b>				
<b>Total</b>	<b>297,682</b>				
At 31 December 2015 <sup>3</sup>					
Secured	302,413	3,818	1.3	1,431	37.5
Overdrafts	2,028	211	10.4	95	78.5
Wealth	2,164	40	1.8	19	47.5
Retail Business Banking	895	43	4.8	19	126.7
Total gross lending	307,500	4,112	1.3	1,564	39.2
Impairment provisions	(1,564 )				
Fair value adjustments	(273 )				
Total	305,663				

<sup>1</sup> Impairment provisions include collective unidentified impairment provisions.

Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries for Overdrafts (31 December 2016: £70 million; 31 December 2015: £90 million) and Retail Business Banking (31 December 2016: £16 million; 31 December 2015: £28 million).

<sup>3</sup> Restated.

62

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**Secured**

The impairment charge increased by £6 million to £104 million in 2016 (31 December 2015: £98 million).

Loans and advances reduced by 2.6 per cent on the Secured book to £295 billion, with reductions in both the Mainstream and buy-to-let portfolios. The closed Specialist portfolio has continued to run-off, reducing by 10.0 per cent to £18 billion.

Impaired loans increased by £286 million to £4,104 million in 2016 and the value of mortgages greater than three months in arrears (excluding reposessions) increased by £128 million to £6,033 million at 31 December 2016 (31 December 2015: £5,905 million). These are both principally due to delayed litigation while changes were made to legal processes. New business quality remained stable and flows into arrears improved.

Impairment provisions as a percentage of impaired loans was 36.6 per cent (31 December 2015: 37.5 per cent).

Against a backdrop of strong improvement in the housing market, with UK prices rising 6 per cent over 2016 (on a quarterly non-seasonally adjusted basis), provisions remain prudent and reflect the latent risks of the current low interest rate environment.

The average indexed LTV of the portfolio at 31 December 2016 improved to 44.0 per cent compared with 46.1 per cent at 31 December 2015. The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent improved to 0.7 per cent at 31 December 2016, compared with 1.1 per cent at 31 December 2015.

The average LTV for new mortgages written in 2016, including participation in the UK Government's Help To Buy scheme, was 64.4 per cent compared with 64.7 per cent for 2015.

Additional controls for new buy-to-let lending were implemented ahead of the regulatory deadline, with no relaxation in risk appetite.

Table 1.10: **Retail Secured loans and advances to customers**

	<b>At 31 Dec 2016 £m</b>	At 31 Dec 2015 £m
Mainstream	<b>222,450</b>	227,267
Buy-to-let	<b>54,460</b>	55,598
Specialist <sup>1</sup>	<b>17,593</b>	19,548
<b>Total Secured</b>	<b>294,503</b>	302,413

<sup>1</sup> Specialist lending has been closed to new business since 2009.

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

	Number of cases		Total mortgage accounts		Value of loans <sup>1</sup>		Total mortgage balances	
	2016	2015	%		2016	2015	%	
At 31 Dec	Cases	Cases	%	%	£m	£m	%	%
Mainstream	<b>35,254</b>	34,850	<b>1.7</b>	1.6	<b>3,865</b>	3,803	<b>1.7</b>	1.7
Buy-to-let	<b>5,324</b>	5,021	<b>1.1</b>	1.0	<b>660</b>	626	<b>1.2</b>	1.1
Specialist	<b>9,078</b>	8,777	<b>7.2</b>	6.4	<b>1,508</b>	1,476	<b>8.6</b>	7.6
Total	<b>49,656</b>	48,648	<b>1.8</b>	1.7	<b>6,033</b>	5,905	<b>2.0</b>	2.0

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

The stock of repossessions increased to 678 cases at 31 December 2016 compared to 654 cases at 31 December 2015.

## 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 2016						
Less than 60%	<b>56.8</b>	<b>52.0</b>	<b>53.8</b>	<b>55.8</b>	<b>56.0</b>	<b>38.3</b>
60% to 70%	<b>17.8</b>	<b>25.4</b>	<b>17.8</b>	<b>19.2</b>	<b>19.3</b>	<b>18.4</b>
70% to 80%	<b>14.0</b>	<b>14.4</b>	<b>13.6</b>	<b>14.0</b>	<b>14.0</b>	<b>15.3</b>
80% to 90%	<b>8.4</b>	<b>6.1</b>	<b>8.6</b>	<b>8.0</b>	<b>7.9</b>	<b>11.9</b>
90% to 100%	<b>2.4</b>	<b>1.5</b>	<b>3.1</b>	<b>2.3</b>	<b>2.2</b>	<b>6.8</b>
Greater than 100%	<b>0.6</b>	<b>0.6</b>	<b>3.1</b>	<b>0.7</b>	<b>0.6</b>	<b>9.3</b>
Total	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Outstanding loan value (£m)	<b>222,450</b>	<b>54,460</b>	<b>17,593</b>	<b>294,503</b>	<b>290,399</b>	<b>4,104</b>
Average loan to value: <sup>1</sup>						
Stock of residential mortgages	<b>41.8</b>	<b>53.7</b>	<b>49.2</b>	<b>44.0</b>		
New residential lending	<b>65.0</b>	<b>61.9</b>	<b>n/a</b>	<b>64.4</b>		
Impaired mortgages	<b>51.8</b>	<b>69.0</b>	<b>61.9</b>	<b>55.8</b>		
At 31 December 2015						
Less than 60%	52.2	45.4	43.7	50.4	50.7	30.9
60% to 70%	19.1	26.8	19.7	20.6	20.6	17.5
70% to 80%	15.5	15.0	15.5	15.4	15.4	16.9
80% to 90%	9.0	8.0	11.6	9.0	8.9	13.3
90% to 100%	3.2	3.9	5.5	3.5	3.4	9.5
Greater than 100%	1.0	0.9	4.0	1.1	1.0	11.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	227,267	55,598	19,548	302,413	298,595	3,818
Average loan to value: <sup>1</sup>						
Stock of residential mortgages	43.6	56.3	53.3	46.1		
New residential lending	65.2	63.0	n/a	64.7		
Impaired mortgages	55.6	74.6	66.8	60.0		

<sup>1</sup> 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 2016, interest only balances as a proportion of total owner occupier balances had reduced to 31.3 per cent (31 December 2015: 33.9 per cent). The average indexed loan to value improved to 43.8 per cent (31 December: 46.6 per cent).

New owner occupier interest only mortgages are subject to conservative underwriting criteria with rigorous controls on customers' ability to repay the principal at the end of term. New interest only mortgages, including those with any element of capital repayments represented 1.9 per cent of new residential mortgages in 2016 (2.8 per cent in 2015<sup>2</sup>).

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

	<b>2016</b>	2015
Interest only balances (£m) <sup>1</sup>	<b>72,651</b>	81,558
Of which, impaired (%)	<b>3.1</b>	2.5
Average loan to value (%)	<b>43.8</b>	46.6
Maturity profile (£m) <sup>2</sup> :		
1 year	<b>2,496</b>	1,709
2-5 years	<b>9,877</b>	10,123
6-10 years	<b>16,990</b>	17,084
>11 years	<b>41,927</b>	51,502
Past term interest only balances (£m) <sup>3</sup>	<b>1,361</b>	1,140
Of which, impaired (%)	<b>10.5</b>	9.7
Average loan to value (%)	<b>31.5</b>	32.5
Negative equity (%)	<b>1.4</b>	1.8

<sup>1</sup> In addition the Group has buy-to-let interest only balances of £48,575 million (2015: £49,751 million) and certain other interest only balances of £3,703 million (2015: £3,705 million).

<sup>2</sup> December 2015 values have been restated to now include the interest only elements of mortgage accounts which consist of partial interest only and partial capital repayment.

<sup>3</sup> Past term interest only balances are reported excluding any element being repaid on a capital and interest basis. December 2015 balances have been restated on the same basis.

### Forborne loans

UK Secured forborne loans and advances reduced by £1,006 million in 2016 to £2,096 million, primarily due to a reduction in recapitalisations with higher levels of historic cases exiting the two year probation period, and a tightening of eligibility criteria during the year. At 31 December 2016, UK Secured loans and advances currently or recently subject to forbearance improved to 0.7 per cent (31 December 2015: 1.0 per cent) of total UK Secured loans and advances.

Overdrafts forborne loans and advances have reduced by £9 million in 2016 to £78 million. At 31 December 2016, Overdrafts loans and advances currently or recently subject to forbearance were 4.0 per cent (31 December 2015: 4.3 per cent) of total overdrafts loans and advances.

Further analysis of the Retail forborne loan balances is set out below:

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

	Total loans and advances which are forborne		Total forborne loans and advances which are impaired		Impairment provisions as % of loans and advances which are forborne	
	At Dec 2016 £m	At Dec 2015 £m	At Dec 2016 £m	At Dec 2015 £m	At Dec 2016 %	At Dec 2015 %
UK Secured lending:						
Temporary forbearance arrangements						
Reduced payment arrangements <sup>1</sup>	<b>428</b>	414	<b>101</b>	41	<b>4.9</b>	4.2
Permanent treatments						
Repair and term extensions <sup>2</sup>	<b>1,668</b>	2,688	<b>116</b>	132	<b>4.7</b>	4.2
Total	<b>2,096</b>	3,102	<b>217</b>	173	<b>4.7</b>	4.2
<b>Overdrafts<sup>3</sup></b>	<b>78</b>	87	<b>61</b>	63	<b>38.0</b>	35.0

<sup>1</sup> Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.

<sup>2</sup> Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and where the borrowers remain as customers at 31 December.

<sup>3</sup> Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

	2016		2015	
	UK Secured £m	Overdrafts £m	UK Secured £m	Overdrafts £m
At 1 January	3,102	87	4,394	89
Classified as forbore during the year	975	50	1,290	53
Written-off/sold	(12 )	(31 )	(25 )	(26 )
Exit from forbearance	(1,741)	(24 )	(2,252)	(22 )
Redeemed or repaid	(200 )	–	(263 )	–
Exchange and other movements	(28 )	(4 )	(42 )	(7 )
At 31 December	2,096	78	3,102	87

### Commercial Banking

The Commercial Banking net impairment charge was £16 million in 2016, compared to a net impairment release of £22 million in 2015, with the increase largely due to one material charge related to a case within the oil & gas sector, rather than a deterioration in the underlying portfolio. Other than this, gross charges remained relatively low in 2016. The portfolio continues to benefit from effective risk management and the continued low interest rate environment. Credit quality of the portfolio and new business remains generally good.

Impaired loans reduced by 14 per cent to £2,179 million at 31 December 2016 compared with £2,543 million at 31 December 2015 and as a percentage of closing loans and advances reduced to 2.2 per cent from 2.5 per cent at 31 December 2015.

Impairment provisions reduced to £824 million at 31 December 2016 (31 December 2015: £1,091 million) and includes collective unidentified impairment provisions of £183 million (31 December 2015: £229 million). Provisions as a percentage of impaired loans reduced from 42.9 per cent to 37.8 per cent during 2016, heavily influenced by the net movement of three material cases with different coverage levels that has impacted the portfolio average.

The UK faces a number of significant headwinds including the changing global economic outlook and the impact of the EU Exit referendum outcome which have the ability to impact the Commercial Banking portfolios.

Commercial Banking remains disciplined within its low risk appetite approach and key credit risks continue to be effectively managed, including early identification and management of potential concern customers. The Group manages and limits exposure to certain sectors and asset classes, and closely monitor credit quality, sector and single name concentrations.

Detailed EU Exit portfolio impact assessments have been undertaken and internal and external key performance indicators are being monitored closely to help identify early signs of any deterioration.

Despite the uncertain economic headwinds, the portfolios are well positioned and monitoring confirms that the Group has yet to see any material deterioration in the credit quality of its portfolios. However, given the challenging environment the Group's portfolios will not be immune and 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**

	2016	2015	Change
	£m	£m	%
SME	(7 )	(22 )	(68 )
Other	23	–	
Total impairment charge	16	(22 )	
Asset quality ratio <sup>1</sup>	0.02%	0.01%	1bp

<sup>1</sup>In respect of loans and advances to customers.

66

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 <sup>1</sup> £m	Impairment provisions as a % of impaired loans %
At 31 December 2016					
SME	29,959	923	3.1	173	18.7
Other	71,217	1,256	1.8	651	51.8
Total gross lending	101,176	2,179	2.2	824	37.8
Impairment provisions	(824 )				
Total	100,352				
At 31 December 2015 <sup>2</sup>					
SME	29,393	1,149	3.9	213	18.5
Other	73,689	1,394	1.9	878	63.0
Total gross lending	103,082	2,543	2.5	1,091	42.9
Impairment provisions	(1,091 )				
Total	101,991				

<sup>1</sup> Impairment provisions include collective unidentified impairment provisions.

<sup>2</sup> Restated.

### SME

–The SME Banking portfolio continues to grow within prudent credit risk appetite parameters.

–Portfolio credit quality has remained stable or improved across all key metrics.

SME continues to benefit from write-backs/releases. There was a net impairment release of £7 million in 2016 compared to a net release of £22 million during 2015.

### Other Commercial Banking

Other Commercial Banking comprises £71,217 million of gross loans and advances to customers in Mid Markets, Global Corporates and Financial Institutions.

–

The Mid Markets business remains UK-focused and credit quality has been generally stable during 2016. The downturn in global oil and gas prices, which began in 2015, has created pressure on some parts of the oilfield services portfolio but this has not translated into a significant increase in defaults or impairment in the Mid Markets book. Political events during 2016, in particular the EU Exit referendum outcome, have brought volatility to financial markets but to date this has not led to a material increase in stress within the Mid Markets portfolio.

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 headwinds particularly relating to the EU Exit referendum outcome and volatile commodity prices in the oil & gas and mining sectors.

The 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 uncertainties created by the EU Exit referendum outcome have reduced activity in the second half of 2016 but the market for UK real estate has continued to be resilient and 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.

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. Overall limits have been relatively stable as the Group continues to prudently manage the portfolio within its conservative risk appetite and clearly defined sector strategies.

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 saw some growth in its UK Direct Real Estate core portfolio during 2016 with business continuing to be written within conservative risk appetite parameters. Excluding £0.5 billion in the Islands Commercial business, Commercial Banking UK Direct Real Estate gross lending stood at £18.5 billion at 31 December 2016.

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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.18: LTV – UK Direct Real Estate

	At 31 December 2016 <sup>1</sup>				At 31 December 2015 <sup>1</sup>			
	Unimpaired £m	Impaired £m	Total £m	%	Unimpaired £m	Impaired £m	Total £m	%
UK exposures >£5m								
Less than 60%	5,721	14	5,735	67.2	4,989	72	5,061	63.7
60% to 70%	1,470	–	1,470	17.2	1,547	6	1,553	19.5
70% to 80%	506	9	515	6.1	610	13	623	7.9
80% to 100%	20	6	26	0.3	75	36	111	1.4
100% to 120%	–	–	–	–	–	8	8	0.1
120% to 140%	–	–	–	–	–	–	–	–
Greater than 140%	–	68	68	0.8	5	100	105	1.3
Unsecured <sup>2</sup>	689	26	715	8.4	487	–	487	6.1
	8,406	123	8,529	100.0	7,713	235	7,948	100.0
UK exposures <£5m <sup>3</sup>	9,563	429	9,992		9,656	508	10,164	
Total	17,969	552	18,521		17,369	743	18,112	

<sup>1</sup> Excludes Islands Commercial UK Direct Real Estate.

<sup>2</sup> Predominantly investment grade corporate CRE lending where the Group is relying on the corporate covenant.

<sup>3</sup> December 2016 <£5m exposures include £9.4 billion within SME which has an LTV profile broadly similar to the >£5m exposures.

## Forborne loans

### Commercial Banking forbearance

At 31 December 2016, £2,645 million (31 December 2015: £3,529 million) of total loans and advances were forborne of which £2,179 million (31 December 2015: £2,543 million) were impaired. Impairment provisions as a percentage of forborne loans and advances increased marginally from 30.9 per cent at 31 December 2015 to 31.2 per cent at 31 December 2016.

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

Impairment  
provisions as  
%

	Total loans and advances		of loans and advances which	
	which are forborne		are forborne	
	2016	2015 <sup>1</sup>	2016	2015 <sup>1</sup>
	£m	£m	%	%
Impaired	2,179	2,543	37.8	42.9
Unimpaired	466	986	–	–
Total	2,645	3,529	31.2	30.9

1 Restated.

All 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)

	2016	2015 <sup>1</sup>
	£m	£m
At 1 January	2,543	3,241
Classified as impaired during the year:		
Exposures >£5m	547	505
Exposures <£5m	124	126
	671	631
Transferred to unimpaired:		
Exposures >£5m but still reported as forborne	–	(15 )
Exposures >£5m no longer reported as forborne	(31 )	(20 )
Exposures <£5m	(81 )	(111 )
	(112 )	(146 )
Written-off	(311 )	(225 )
Asset disposal/sales of impaired assets	(33 )	(48 )
Drawdowns/repayments	(595 )	(693 )
Exchange and other movements	16	(217 )
At 31 December	2,179	2,543

1 Restated.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**Unimpaired loans and advances**

Unimpaired forborne loans and advances were £466 million at 31 December 2016 (31 December 2015: £986 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 2016 by type of forbearance:

**Table 1.21: Commercial Banking unimpaired forborne loans and advances<sup>1</sup> (audited)**

	31 Dec 2016 £m	31 Dec 2015 £m
Type of unimpaired forbearance:		
Exposures >£5m		
Covenants	153	310
Extensions/alterations	7	350
Multiple	21	9
	181	669
Exposures <£5m	285	317
Total	466	986

<sup>1</sup> Material portfolios only.

**Table 1.22: Movement in Commercial Banking unimpaired forborne loans and advances >£5m<sup>1</sup> (audited)**

	2016 £m	2015 £m
At 1 January	669	1,450
Classified as impaired during the year	(63 )	(141 )
Cured no longer forborne	(413)	(655 )
Classified as forborne during the year	88	156
Transferred from impaired but still reported as forborne <sup>1</sup>	–	15
Asset disposal/sales	–	–
Net drawdowns/repayments	(100)	(153 )
Exchange and other movements	–	(3 )
At 31 December	181	669

<sup>1</sup> Balances exclude intra-year movements.

## Consumer Finance

UK Loans and advances increased during 2016, driven by strong growth ahead of the market in the UK Motor Finance portfolio, and continued growth in line with the market in the Credit Cards portfolio.

Asset quality remains strong, and the quality of new business continues to be good.

Credit risk appetite has been maintained, and the Group has robust indebtedness and affordability controls to ensure new lending is sustainable for its customers.

The impairment charge increased by £47 million to £282 million largely due to the UK Motor Finance portfolio, in which there was overall growth as well as the non-recurrence of a favourable one-off in 2015.

Credit Cards balances grew broadly in line with the market, and underlying credit quality remained strong. Impaired loans fell by £59 million due to continued reductions in recoveries, and impairment provisions as a percentage of impaired loans remained stable.

Loans balances contracted marginally and underlying credit quality remained strong. Impaired loans fell by £90 million largely due to reductions in recoveries, and impairment provisions as a percentage of impaired loans remained broadly stable.

Growth in UK Motor Finance loans and advances was ahead of the market, in part due to strategic relationships with business partners such as Jaguar Land Rover, which also contributed to the strong underlying credit quality in the portfolio. Impaired loans fell by £14 million largely due to a reclassification of impaired balances for some finance leases, and on an underlying basis grew broadly in line with the portfolio. Impairment provisions as a percentage of impaired loans increased, reflecting the reclassification of impaired balances, and portfolio growth coupled with a prudent approach to residual value.

69

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.23: Consumer Finance impairment charge

	2016	2015	Change
	£m	£m	%
Credit Cards	136	129	(5 )
Loans	70	83	16
UK Motor Finance	75	22	
Europe	1	1	–
	282	235	(20 )
Asset quality ratio	0.83%	0.77%	6bp

Table 1.24: Consumer Finance impaired loans and provisions

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions <sup>1</sup> £m	Impairment provisions as a % of impaired loans <sup>2</sup> %
At 31 December 2016					
Credit cards	9,843	307	3.1	157	81.8
Loans	7,767	277	3.6	92	81.4
UK Motor Finance	11,555	120	1.0	127	105.8
Europe	6,329	41	0.6	20	48.8
Total gross lending	35,494	745	2.1	396	85.0
Impairment provisions	(396 )				
Fair value adjustments	–				
Total	35,098				
At 31 December 2015 <sup>3</sup>					
Credit cards	9,425	366	3.9	153	81.8
Loans	7,889	367	4.7	102	83.6
UK Motor Finance	9,582	134	1.4	90	67.2
Europe	4,931	43	0.9	22	51.2
Total gross lending	31,827	910	2.9	367	75.5
Impairment provisions	(367 )				
Fair value adjustments	(9 )				
Total	31,451				

<sup>1</sup> Impairment provisions include collective unidentified impairment provisions.

Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries for Cards (31 December 2016: £115 million; 31 December 2015: £179 million) and Loans (31 December 2016: £164 million; 31 December 2015: £245 million).

<sup>3</sup> Restated.

### Forborne loans

At 31 December 2016, total loans and advances currently or recently subject to forbearance as a percentage of total loans and advances had reduced across the major Consumer Finance portfolios with decreases in Consumer Credit Cards and Loans offset by an increase in UK Motor Finance. (31 December 2016: 1.4 per cent; 31 December 2015: 1.6 per cent).

Table 1.25: **Consumer Finance forborne loans and advances (audited)**

	Total loans and advances which are forborne		Total forborne loans and advances which are impaired		Impairment provisions as % of loans and advances which are forborne	
	31 Dec 2016	31 Dec 2015	31 Dec 2016	31 Dec 2015	31 Dec 2016	31 Dec 2015
	£m	£m	£m	£m	%	%
Consumer Credit Cards <sup>1</sup>	212	225	119	120	29.0	26.8
Loans <sup>2</sup>	49	60	46	56	44.4	47.2
UK Motor Finance Retail <sup>2</sup>	117	100	62	51	27.0	25.5

<sup>1</sup> Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months. Permanent changes, such as returning a Card account in arrears to an in-order status, which commenced during the last 24 months for existing customers as at 31 December are also included.

<sup>2</sup> Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months. Permanent changes, such as refinancing, for existing customers as at 31 December are also included.

70

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The movements in forborne loans and advances during the year were:

Table 1.26: **Movement in Consumer Finance forborne loans and advances (audited)**

	2016			2015		
	Consumer credit cards	UK Motor Finance Retail Loans	UK Motor Finance Retail	Consumer credit cards	UK Motor Finance Retail	UK Motor Finance Retail
	£m	£m	£m	£m	£m	£m
At 1 January	225	60	100	234	73	109
Classified as forborne during the year	110	34	82	108	16	61
Written off/sold	(46)	(24)	(16)	(48)	(29)	(15)
Exit from forbearance	(43)	(4)	(22)	(36)	(4)	(21)
Redeemed or repaid	(9)	(6)	(16)	(9)	(6)	(19)
Exchange and other movements	(25)	(11)	(11)	(24)	10	(15)
At 31 December	212	49	117	225	60	100

### Run-off

The Ireland retail portfolio continues to reduce in volume due to closed book attrition (3 per cent year on year), however exposure has increased by £457 million to £4,497 million in 2016 (31 December 2015: £4,040 million) due to the foreign exchange impact of sterling weakening, partly offset by capital repayments.

Ireland retail loans and advances with an indexed LTV in excess of 100 per cent improved to £1,240 million (27.8 per cent) at 31 December 2016, compared with £1,269 million (31.4 per cent) at 31 December 2015. Of this amount £70 million were impaired (31 December 2015: £71 million).

The Corporate real estate and other corporate portfolio has continued to reduce in line with expectations. Net loans and advances reduced by £337 million, from £1,128 million at 31 December 2015 to £791 million at 31 December 2016.

Total net external assets for the Specialist finance asset based run-off portfolio reduced to £4,668 million at 31 December 2016 (gross £4,779 million), from £5,552 million (gross £5,742 million) for 2015. Assets include Ship Finance, Aircraft Finance, Leasing and Infrastructure loans and advances, as well as the reducing Treasury Asset legacy investment portfolio and operating leases.

Table 1.27: **Run-off impairment charge**

Edgar Filing: Lloyds Banking Group plc - Form 20-F

	2016	2015	Change
	£m	£m	%
Ireland retail	(1 )	(5 )	(80 )
Ireland corporate and commercial real estate	(13 )	72	
Corporate real estate and other corporate	1	21	95
Specialist finance	(2 )	(45 )	(96 )
Other	(11 )	(35 )	(69 )
Total	(26 )	8	
Asset quality ratio <sup>1</sup>	(0.15%)	0.20%	(35)bp

<sup>1</sup> In respect of loans and advances to customers.

71

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.28: 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 2016					
Ireland retail	4,497	138	3.1	133	96.4
Ireland corporate	1	1	100.0	–	–
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				
At 31 December 2015					
Ireland retail	4,040	132	3.3	120	90.9
Ireland corporate	29	–	–	–	–
Ireland commercial real estate	8	5	62.5	–	–
Corporate real estate and other corporate	1,873	1,410	75.3	745	52.8
Specialist finance	4,190	361	8.6	189	52.4
Other	1,282	117	9.1	96	82.1
Total gross lending	11,422	2,025	17.7	1,150	56.8
Impairment provisions	(1,150 )				
Total	10,272				

**Forborne loans****Run-off Ireland retail lending**

At 31 December 2016, £156 million or 3.5 per cent (31 December 2015: £169 million or 4.2 per cent) of Irish retail secured loans and advances were subject to current or recent forbearance. Of this amount, £19 million (31 December 2015: £26 million) were impaired.

**Run-off Corporate real estate, other corporate and Specialist Finance**

At 31 December 2016 £998 million (31 December 2015 £1,780 million) of total loans and advances were forborne of which £995 million (31 December 2015: £1,771 million) were impaired. Impairment provisions as a percentage of

forborne loans and advances decreased from 52.5 per cent at 31 December 2015 to 51.1 per cent at 31 December 2016.

Unimpaired forborne loans and advances were £3 million at 31 December 2016 (31 December 2015: £9 million).

### Impaired loans and advances

The movements in Run-off corporate real estate, other corporate and Specialist Finance impaired forborne loans and advances were as follows:

**Table 1.29: Movement in Run-off corporate real estate, other corporate and Specialist Finance impaired forborne loans and advances (audited)**

	2016	2015
	£m	£m
At 1 January	1,771	1,912
Classified as impaired during the year:		
Exposures >£5m	20	414
Exposures <£5m	19	11
	39	425
Transferred to unimpaired:		
Exposures >£5m but still reported as forborne during the year	–	(13 )
Exposures <£5m	(8 )	(11 )
	(8 )	(24 )
Write offs	(478 )	(238 )
Asset disposal/sales of impaired assets	(405 )	(763 )
Drawdowns/repayments	(24 )	(19 )
Exchange and other movements	100	478
At 31 December	995	1,771

72



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **Eurozone exposures**

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2016. 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 Group Financial Stability Forum (GFSF) 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 IFRS basis and are disclosed based on the counterparty rather than the collateral (repos and stock 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. For these funds, 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 1.30: Selected Eurozone exposures

	Sovereign debt		Financial institutions				Insurance		Total £m
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other <sup>1</sup> £m	Asset backed securities £m	Corporate £m	Personal <sup>2</sup> £m	assets <sup>1</sup> £m	
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
At 31 December 2015									
Ireland	–	–	748	445	87	731	3,921	–	5,932
Spain	–	–	77	102	–	870	39	9	1,097
Portugal	–	–	7	–	–	86	6	–	99
Italy	–	–	32	–	–	51	–	73	156
Greece	–	–	–	–	–	1	–	–	1
	–	–	864	547	87	1,739	3,966	82	7,285

<sup>1</sup> Excludes reverse repurchase exposure to Institutional funds domiciled in Ireland secured by UK gilts of £14,506 million (2015: £11,267 million) on a gross basis.

<sup>2</sup> Ireland Retail exposures have increased by c.£0.4 billion as a result of the depreciation of sterling against the Euro c.£0.7 billion offset by asset reductions primarily driven by repayments of c.£0.3 billion.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

Table 1.31: Other Eurozone exposures

	Sovereign debt		Financial institutions		Asset			Insurance assets £m	Total £m
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other <sup>1</sup> £m	backed securities £m	Corporate £m	Personal £m		
<b>At 31 December 2016</b>									
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
	<b>1,623</b>	<b>8,888</b>	<b>4,198</b>	<b>2,759</b>	<b>934</b>	<b>7,247</b>	<b>6,854</b>	<b>1,862</b>	<b>34,365</b>
<b>At 31 December 2015</b>									
Netherlands	281	11,515	328	164	37	1,275	4,863	428	18,891
France	173	–	1,809	216	98	1,953	64	953	5,266
Germany	151	97	888	21	66	1,924	177	573	3,897
Luxembourg	–	–	74	1,178	618	1,614	–	36	3,520
Belgium	20	–	830	1	–	298	–	51	1,200
All other Eurozone countries	15	–	403	–	–	342	–	80	840
	640	11,612	4,332	1,580	819	7,406	5,104	2,121	33,614

<sup>1</sup> Excludes reverse repurchase exposure to Institutional funds secured by UK gilts of £2,679 million (2015: £1,955 million) on a gross basis.

## Environmental risk management

The Group ensures appropriate management of the environmental impact 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 Business Responsibility.

Within Commercial Banking, an electronic environmental risk screening system has been the primary mechanism for assessing environmental risk in lending transactions. This system provides screening of location specific and sector based risks that may be present in a transaction. Identified risk results in the transaction 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 in environmental risk management as part of the standard suite of credit risk courses. Supporting 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.

The Group has been a signatory to the Equator Principles since 2006 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.

**Table 1.32: Environmental risk management approach**

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LOAN PORTFOLIO

In the following tables, where lending and the related impairment allowances are analysed between domestic and international, the classification as domestic or international is based on the location of the office recording the transaction, except for certain lending of the international business booked in London including the Group's lending in Ireland which, following the merger of Bank of Scotland (Ireland) Limited into Bank of Scotland plc, is held on the balance sheet of Bank of Scotland plc in the UK but is reported as international.

## 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.

	2016	2015	2014	2013	2012
	£m	£m	£m	£m	£m
Loans and advances to banks	26,902	25,117	26,155	25,365	32,760
Loans and advances to customers:					
Mortgages	306,682	312,877	333,318	335,611	337,879
Other personal lending	20,761	20,579	23,123	23,230	28,334
Agriculture, forestry and fishing	7,269	6,924	6,586	6,051	5,531
Energy and water supply	2,320	3,247	3,853	4,414	3,321
Manufacturing	7,285	5,953	6,000	7,650	8,530
Construction	4,535	4,952	6,425	7,024	7,526
Transport, distribution and hotels	13,320	13,526	15,112	22,294	26,568
Postal and telecommunications	2,564	2,563	2,624	2,364	1,397
Financial, business and other services	49,197	43,072	44,979	42,478	48,729
Property companies	32,192	32,228	36,682	44,277	52,388
Lease financing	2,628	2,751	3,013	4,435	6,477
Hire purchase	11,617	9,536	7,403	5,090	5,334
<b>Total loans</b>	<b>487,272</b>	<b>483,325</b>	<b>515,273</b>	<b>530,283</b>	<b>564,774</b>
Allowance for impairment losses	(2,412 )	(3,033 )	(6,414 )	(11,966 )	(15,253 )
<b>Total loans and advances net of allowance for impairment losses</b>	<b>484,860</b>	<b>480,292</b>	<b>508,859</b>	<b>518,317</b>	<b>549,521</b>

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013 or later years. The analysis of loans and advances at 31 December 2012 between domestic and international offices is as follows:

	Domestic £m	International £m	Total £m
Loans and advances to banks	32,073	687	32,760
Loans and advances to customers:			
Mortgages	322,687	15,192	337,879
Other personal lending	26,119	2,215	28,334
Agriculture, forestry and fishing	5,482	49	5,531
Energy and water supply	1,773	1,548	3,321
Manufacturing	7,246	1,284	8,530
Construction	6,481	1,045	7,526
Transport, distribution and hotels	22,205	4,363	26,568
Postal and telecommunications	1,239	158	1,397
Financial, business and other services	44,155	4,574	48,729
Property companies	43,683	8,705	52,388
Lease financing	5,306	1,171	6,477
Hire purchase	4,970	364	5,334
<b>Total loans</b>	<b>523,419</b>	<b>41,355</b>	<b>564,774</b>
Allowance for impairment losses	(7,076 )	(8,177 )	(15,253 )
<b>Total loans and advances net of allowance for impairment losses</b>	<b>516,343</b>	<b>33,178</b>	<b>549,521</b>

75

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## SUMMARY OF LOAN LOSS EXPERIENCE

The following table analyses the movements in the allowance for impairment losses on loans and advances to banks and customers for each of the five years listed.

	2016	2015	2014	2013	2012
	£m	£m	£m	£m	£m
<b>Balance at beginning of year</b>	<b>3,033</b>	6,414	11,966	15,253	18,746
<b>Exchange and other adjustments</b>	<b>69</b>	(246 )	(410 )	291	(380 )
<b>Disposal of businesses</b>	<b>-</b>	(82 )	-	(176 )	-
<b>Advances written off:</b>					
Loans and advances to customers:					
Mortgages	(42 )	(71 )	(87 )	(601 )	(133 )
Other personal lending	(728 )	(853 )	(1,329 )	(1,437 )	(2,267 )
Agriculture, forestry and fishing	(1 )	(1 )	(8 )	(11 )	(45 )
Energy and water supply	(9 )	(73 )	-	(102 )	(77 )
Manufacturing	(19 )	(126 )	(59 )	(130 )	(226 )
Construction	(96 )	(21 )	(157 )	(84 )	(654 )
Transport, distribution and hotels	(64 )	(728 )	(1,119 )	(798 )	(458 )
Postal and telecommunications	(189 )	(11 )	-	(14 )	(7 )
Financial, business and other services	(712 )	(604 )	(946 )	(1,030 )	(1,071 )
Property companies	(215 )	(1,648 )	(2,669 )	(1,891 )	(3,554 )
Lease financing	-	(31 )	(4 )	(10 )	(75 )
Hire purchase	(36 )	(37 )	(54 )	(121 )	(130 )
Loans and advances to banks	-	-	-	(3 )	(10 )
<b>Total advances written off</b>	<b>(2,111)</b>	(4,204)	(6,432)	(6,232)	(8,707)
<b>Recoveries of advances written off:</b>					
Loans and advances to customers:					
Mortgages	44	35	18	28	53
Other personal lending	329	366	600	408	757
Energy and water supply	3	5	-	-	-
Manufacturing	80	-	-	-	-
Construction	78	-	-	-	-
Transport, distribution and hotels	50	63	-	-	1
Financial, business and other services	241	193	-	-	-
Property companies	34	101	-	-	4
Lease financing	-	-	-	-	2
Hire purchase	2	1	63	20	26
<b>Total recoveries of advances written off</b>	<b>861</b>	764	681	456	843
<b>Total net advances written off</b>	<b>(1,250)</b>	(3,440)	(5,751)	(5,776)	(7,864)

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2016	2015	2014	2013	2012
	£m	£m	£m	£m	£m
<b>Effect of unwinding of discount recognised through interest income</b>	<b>(32 )</b>	<b>(56 )</b>	<b>(126 )</b>	<b>(351 )</b>	<b>(374 )</b>
<b>Allowances for impairment losses charged against income for the year:</b>					
Loans and advances to customers:					
Mortgages	<b>(23 )</b>	33	(138 )	224	278
Other personal lending	<b>438</b>	437	536	920	881
Agriculture, forestry and fishing	<b>3</b>	1	2	–	54
Energy and water supply	<b>(4 )</b>	35	28	95	71
Manufacturing	<b>(48 )</b>	23	(4 )	31	236
Construction	<b>143</b>	13	(81 )	66	326
Transport, distribution and hotels	<b>(35 )</b>	(88 )	198	421	649
Postal and telecommunications	<b>191</b>	(2 )	6	(3 )	8
Financial, business and other services	<b>6</b>	77	179	552	824
Property companies	<b>(166 )</b>	(140 )	40	457	1,725
Lease financing	<b>15</b>	31	(1 )	(26 )	26
Hire purchase	<b>72</b>	23	(30 )	(12 )	47
Loans and advances to banks	–	–	–	–	–
<b>Total allowances for impairment losses charged against income for the year</b>	<b>592</b>	443	735	2,725	5,125
<b>Total balance at end of year</b>	<b>2,412</b>	3,033	6,414	11,966	15,253
<b>Ratio of net write-offs during the year to average loans outstanding during the year</b>	<b>0.3%</b>	0.8%	1.1%	1.1%	1.4%

The Group's impairment allowances in respect of loans and advances to banks and customers decreased by £621 million, or 20 per cent, from £3,033 million at 31 December 2015 to £2,412 million at 31 December 2016. This decrease resulted from a charge to the income statement of £592 million being more than offset by net advances written off of £1,250 million (advances written off of £2,111 million less recoveries £861 million). The increase in the charge to the income statement of £149 million, or 34 per cent, from £443 million in 2015 to £592 million in 2016 reflects lower levels of releases and write-backs rather than an underlying deterioration in credit quality. By category of lending, the most significant elements of the charge to the income statement were charges of £438 million in respect of other personal lending, £143 million in respect of construction and £191 million in respect of postal and telecommunications together with a credit of £166 million in respect of property companies. Of the net advances written off of £1,250 million, £399 million related to other personal lending, £471 million related to financial, business and other services and £181 million to property companies.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013 or later years. The analysis of movements in the allowance for impairment losses on loans and advances to banks and customers for the year ended 31 December 2012 between domestic and international offices is as follows:

	Domestic £m	International £m	Total £m
<b>Balance at beginning of year</b>	8,025	10,721	18,746
<b>Exchange and other adjustments</b>	(24 )	(356 )	(380 )
<b>Advances written off:</b>			
Loans and advances to customers:			
Mortgages	(96 )	(37 )	(133 )
Other personal lending	(2,258 )	(9 )	(2,267 )
Agriculture, forestry and fishing	(11 )	(34 )	(45 )
Energy and water supply	(68 )	(9 )	(77 )
Manufacturing	(75 )	(151 )	(226 )
Construction	(477 )	(177 )	(654 )
Transport, distribution and hotels	(140 )	(318 )	(458 )
Postal and telecommunications	(1 )	(6 )	(7 )
Financial, business and other services	(919 )	(152 )	(1,071 )
Property companies	(528 )	(3,026 )	(3,554 )
Lease financing	(74 )	(1 )	(75 )
Hire purchase	(129 )	(1 )	(130 )
Loans and advances to banks	(10 )	–	(10 )
<b>Total advances written off</b>	<b>(4,786 )</b>	<b>(3,921 )</b>	<b>(8,707 )</b>
<b>Recoveries of advances written off:</b>			
Loans and advances to customers:			
Mortgages	53	–	53
Other personal lending	751	6	757
Agriculture, forestry and fishing	–	–	–
Energy and water supply	–	–	–
Manufacturing	–	–	–
Construction	–	–	–
Transport, distribution and hotels	1	–	1
Financial, business and other services	–	–	–
Property companies	–	4	4
Lease financing	2	–	2
Hire purchase	26	–	26
<b>Total recoveries of advances written off</b>	<b>833</b>	<b>10</b>	<b>843</b>
<b>Total net advances written off</b>	<b>(3,953 )</b>	<b>(3,911 )</b>	<b>(7,864 )</b>

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	Domestic £m	International £m	Total £m
<b>Effect of unwinding of discount recognised through interest income</b>	(405 )	31	(374 )
Allowances for impairment losses charged against income for the year:			
Loans and advances to customers:			
Mortgages	32	246	278
Other personal lending	1,121	(240 )	881
Agriculture, forestry and fishing	15	39	54
Energy and water supply	77	(6 )	71
Manufacturing	81	155	236
Construction	221	105	326
Transport, distribution and hotels	289	360	649
Postal and telecommunications	–	8	8
Financial, business and other services	734	90	824
Property companies	776	949	1,725
Lease financing	37	(11 )	26
Hire purchase	50	(3 )	47
<b>Total allowances for impairment losses charged against income for the year</b>	<b>3,433</b>	<b>1,692</b>	<b>5,125</b>
<b>Total balance at end of year</b>	<b>7,076</b>	<b>8,177</b>	<b>15,253</b>

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

	<b>2016</b>		2015		2014		2013		2012	
	<b>Percentage of loans in each category to total loans</b>		Percentage of loans in each category to total loans		Percentage of loans in each category to total loans		Percentage of loans in each category to total loans		Percentage of loans in each category to total loans	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>	<b>Allowance</b>
	<b>£m</b>	<b>£m</b>	<b>%</b>	<b>%</b>	<b>£m</b>	<b>£m</b>	<b>%</b>	<b>%</b>	<b>£m</b>	<b>%</b>
<b>Balance at year end applicable to:</b>										
Loans and advances to banks	–	–	<b>5.5</b>	5.2	–	–	5.1	4.8	3	5.8
Loans and advances to customers:										
Mortgages	<b>576</b>	479	<b>63.0</b>	64.7	460	657	64.7	63.5	1,113	60.0
Other personal lending	<b>356</b>	388	<b>4.3</b>	4.3	607	919	4.5	4.4	1,147	5.0
Agriculture, forestry and fishing	<b>13</b>	15	<b>1.5</b>	1.4	18	38	1.3	1.1	67	1.0
Energy and water supply	<b>6</b>	20	<b>0.5</b>	0.7	61	149	0.7	0.8	191	0.6

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Manufacturing	<b>84</b>	<b>1.5</b>	70	1.2	179	1.2	296	1.4	337	1.5
Construction	<b>319</b>	<b>0.9</b>	165	1.0	158	1.3	395	1.3	504	1.3
Transport, distribution and hotels	<b>161</b>	<b>2.7</b>	219	2.8	1,051	2.9	1,954	4.2	2,162	4.7
Postal and telecommunications	<b>5</b>	<b>0.5</b>	4	0.5	17	0.5	11	0.4	40	0.2
Financial, business and other services	<b>312</b>	<b>10.1</b>	811	8.9	1,225	8.7	2,293	8.0	2,764	8.6
Property companies	<b>470</b>	<b>6.6</b>	790	6.7	2,553	7.1	5,145	8.3	6,664	9.3
Lease financing	<b>–</b>	<b>0.5</b>	–	0.6	1	0.6	6	0.8	33	1.1
Hire purchase	<b>110</b>	<b>2.4</b>	72	2.0	84	1.4	103	1.0	228	0.9
<b>Total balance at year end</b>	<b>2,412</b>	<b>100.0</b>	3,033	100.0	6,414	100.0	11,966	100.0	15,253	100.0

79

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013 or later years. The analysis of the coverage of the allowance for loan losses at 31 December 2012 between domestic and international offices is as follows:

	Domestic		Foreign		Total	
	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %
2012						
<b>Balance at year end applicable to:</b>						
Loans and advances to banks	3	6.1	–	1.7	3	5.8
Loans and advances to customers:						
Mortgages	106	62.0	1,007	36.8	1,113	60.0
Other personal lending	1,064	5.0	83	5.4	1,147	5.0
Agriculture, forestry and fishing	57	1.0	10	0.1	67	1.0
Energy and water supply	177	0.3	14	3.7	191	0.6
Manufacturing	194	1.4	143	3.1	337	1.5
Construction	215	1.2	289	2.5	504	1.3
Transport, distribution and hotels	715	4.2	1,447	10.6	2,162	4.7
Postal and telecommunications	10	0.2	30	0.4	40	0.2
Financial, business and other services	2,008	8.4	756	11.1	2,764	8.6
Property companies	2,307	8.3	4,357	21.0	6,664	9.3
Lease financing	14	1.0	19	2.8	33	1.1
Hire purchase	206	0.9	22	0.8	228	0.9
Total	7,076	100.0	8,177	100.0	15,253	100.0

80

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**RISK ELEMENTS IN THE LOAN PORTFOLIO**

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

**NON-PERFORMING LENDING**

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

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

The Group complies with IFRS 7, which requires more detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, the table below shows separately those loans that are (i) neither past due nor impaired, (ii) past due but not impaired, (iii) impaired, not requiring a provision and (iv) impaired with a provision.

(audited)	Loans and advances to customers					Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	
<b>31 December 2016</b>						
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	–

Edgar Filing: Lloyds Banking Group plc - Form 20-F

<b>Gross</b>	<b>26,902</b>	<b>307,963</b>	<b>41,294</b>	<b>112,414</b>	<b>461,671</b>	<b>33,079</b>
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
31 December 2012						
Neither past due nor impaired	32,726	319,613	41,223	117,152	477,988	14,551
Past due but not impaired	31	12,880	922	1,527	15,329	–
Impaired – no provision required	–	741	1,530	1,504	3,775	–
– provision held	3	7,391	2,124	33,003	42,518	–
Gross	32,760	340,625	45,799	153,186	539,610	14,551

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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The loans that are past due but not impaired are further analysed in the table below according to the number of days that have elapsed since the last payment was due from the borrower.

(audited)	Loans and advances to customers				Total £m	Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Commercial £m		
<b>31 December 2016</b>						
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	–
<b>Total</b>	<b>14</b>	<b>7,340</b>	<b>386</b>	<b>305</b>	<b>8,031</b>	<b>–</b>
<b>31 December 2015</b>						
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	–
<b>Total</b>	<b>111</b>	<b>8,233</b>	<b>393</b>	<b>463</b>	<b>9,089</b>	<b>–</b>
<b>31 December 2014</b>						
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	–
<b>Total</b>	<b>152</b>	<b>10,311</b>	<b>674</b>	<b>488</b>	<b>11,473</b>	<b>–</b>
<b>31 December 2013</b>						
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	–
<b>Total</b>	<b>146</b>	<b>12,329</b>	<b>580</b>	<b>786</b>	<b>13,695</b>	<b>–</b>
<b>31 December 2012</b>						
0-30 days	–	5,996	744	860	7,600	–
30-60 days	3	2,667	138	131	2,936	–
60-90 days	2	1,750	29	328	2,107	–

Edgar Filing: Lloyds Banking Group plc - Form 20-F

90-180 days	6	2,467	5	56	2,528	–
Over 180 days	20	–	6	152	158	–
Total	31	12,880	922	1,527	15,329	–

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

82



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## POTENTIAL PROBLEM LOANS

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

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.

(audited)	Loans and advances to customers				Total £m	Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Commercial £m		
<b>31 December 2016</b>						
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		–
<b>Total</b>	<b>26,888</b>	<b>296,303</b>	<b>39,478</b>	<b>109,364</b>	<b>445,145</b>	<b>33,079</b>
<b>31 December 2015</b>						
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		–
<b>Total</b>	<b>25,006</b>	<b>302,063</b>	<b>38,886</b>	<b>100,001</b>	<b>440,950</b>	<b>33,174</b>
<b>31 December 2014</b>						
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		–
<b>Total</b>	<b>26,003</b>	<b>320,324</b>	<b>37,886</b>	<b>106,768</b>	<b>464,978</b>	<b>36,725</b>
<b>31 December 2013</b>						
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

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Below standard, but not impaired	2	663	745	2,390		1
Total	25,219	318,668	36,789	107,764	463,221	29,443
31 December 2012						
Good quality	32,173	313,372	30,924	60,049		14,514
Satisfactory quality	174	4,532	8,579	33,477		28
Lower quality	10	552	862	18,153		6
Below standard, but not impaired	369	1,157	858	5,473		3
Total	32,726	319,613	41,223	117,152	477,988	14,551

For further details see note 52 on page F-90.

**INTEREST FOREGONE ON NON-PERFORMING LENDING**

The table below summarises the interest foregone on impaired lending.

	<b>2016</b>
	<b>£m</b>
Interest income that would have been recognised under original contract terms	<b>317</b>
Interest income included in profit	<b>(205)</b>
<b>Interest foregone</b>	<b>112</b>

83

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## 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)(1) to the financial statements. The table below sets out loans that are forborne at 31 December 2016, 2015 and 2014, separately identifying those loans that are also impaired:

	<b>Total forborne loans and advances which are not impaired £m</b>	<b>Total forborne loans and advances which are impaired £m</b>	<b>Total loans and advances which are forborne £m</b>	<b>Impairment allowance as a % of loans and advances which are forborne %</b>
<b>At 31 December 2016</b>				
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	466	2,179	2,645	31.2
Run off: Corporate Real Estate, other Corporate and Specialist Finance	3	995	998	51.1
<b>At 31 December 2015</b>				
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	986	2,528	3,514	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
<b>At 31 December 2014</b>				
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

Edgar Filing: Lloyds Banking Group plc - Form 20-F

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

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 forbore loans is set out on pages 56 to 59 and pages 65 to 72.

#### **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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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.

	<b>% of assets</b>	<b>Total £m</b>	<b>Governments and official institutions £m</b>	<b>Banks and other financial institutions £m</b>	<b>Commercial, industrial and other £m</b>
<b>At 31 December 2016:</b>					
United States of America	<b>1.6</b>	<b>13,224</b>	<b>7,564</b>	<b>1,718</b>	<b>3,942</b>
At 31 December 2015:					
United States of America	1.5	11,748	6,349	952	4,447
At 31 December 2014:					
United States of America	1.3	11,437	7,838	1,177	2,422

At 31 December 2016, United States of America had commitments of £2,168 million.

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.

At 31 December 2014, no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CONDUCT RISK**

**DEFINITION**

Conduct risk is defined as the risk of customer detriment or regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

**EXPOSURES**

The Group faces significant conduct risks, which affect all aspects of the Group's operations, all types of customers and other stakeholders. These can be considered across two main categories; customer conduct risks and market conduct risks. Customer conduct risks are those that have a direct impact on a customer – or group of customers – and can materialise through products or services not meeting the needs of its customers; sales processes resulting in poor customer outcomes; or the failure to deal with a customer's complaint effectively which in turn may lead to a referral to the Financial Ombudsman Service. Market conduct risks can exist where activity taken can disrupt the fair and effective operation of a market in which the Group is active. Market conduct risks can arise from the mismanagement of market sensitive information, the failure to identify and report suspicious transactions or orders, or through inaccurate benchmark submissions.

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. 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. There is also a significant regulatory focus on market misconduct, resultant from previous issues around LIBOR and FX.

**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 have been agreed for all products to support a consistent approach. These contain a range of product design,

sales and post-sales metrics to provide a more holistic view of conduct risks; each product also has additional bespoke metrics. The common metrics are sales volume, product governance adherence, target market, outcome testing: meets customer needs, outcome testing: information disclosure, outcome testing: regulatory compliance, retention, usage, claims (decline rates), complaints, Financial Ombudsman Service uphold rate and complaints outcome testing. Each of the tolerances for the metrics are agreed for the individual product and are tracked monthly. At a consolidated level these metrics are part of the Board approved risk appetite. The Group also continues to measure the effectiveness of the overall strategic focus on conduct within the divisions and functions and its impact on customer outcomes and the effective implementation of the Customer Vulnerability agenda through the Group Customer First Committee (GCFC).

In relation to market conduct, relevant metrics are being established, and will continue to evolve in line with external developments. These cover a range of topics including the management of confidential and market sensitive information; and the way in which conflicts of interest are managed.

## MITIGATION

The Group takes a range of mitigating actions with respect to this risk. The transition of the customer-focused UK centric strategy into the Business has strengthened its culture and values, improved systems and processes, and implemented more effective controls. These actions are being further embedded throughout the Group (across all business areas and all supporting functional areas) through the continued evolution of the strategic focus on conduct within business as usual supported by the GCFC, including:

Conduct risk appetite established at Group and business area level, with metrics included in the Board Risk Appetite to ensure ongoing due-focus;

Customer needs explicitly considered within business and product level planning and strategy, with Divisional plans reviewed and challenged by the 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;

Establishment of the Customer Vulnerability Framework, which operates at a senior level to prioritise change, drive implementation and ensure consistency across the Group;

Development of the Group's Customer Journey Strategy and Framework to support its 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 customers to ensure consistent delivery of needs met.

The Group has also prioritised activity designed to reinforce good conduct in its engagement with the markets in which it operates. This has included the creation of a Market Conduct Steering Committee, training for relevant colleagues, the development of enhanced procedures, and the enhancement of preventative and detective controls including the Group's trade surveillance and continuous surveillance capability.

The Group's leadership team, through the GCFC, has oversighted and approved the transition of the Conduct Strategy within the business as usual to support the development of the right customer centric culture. 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 current customer treatment concerns, and those relating to the fairness and effectiveness of markets, to ensure that the Group's strategic conduct focus in business as usual continues to meet evolving stakeholder expectations.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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. The GCFC has responsibility for monitoring and reviewing integrated measurement of enhanced outcomes, customer views and cultural transformation, 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. Monitoring activity has also increased in scope to cover trading and communication surveillance, and the monitoring and testing of controls relevant to the Group's market conduct agenda.

**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 1.33 (below) 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 1.33: **Market risk linkage to the balance sheet**

	<b>Total £m</b>	<b>Banking Trading book only £m</b>	<b>Non-trading £m</b>	<b>Insurance £m</b>	<b>Primary market risk factor</b>
<b>2016</b>					
Assets					

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Cash and balances at central banks	<b>47,452</b>	–	<b>47,452</b>	–	Interest rate
Trading and other financial assets at fair value through profit or loss	<b>151,174</b>	<b>45,247</b>	<b>4,039</b>	<b>101,888</b>	Interest rate, foreign exchange, credit spread
Derivative financial instruments	<b>36,138</b>	<b>30,951</b>	<b>2,713</b>	<b>2,474</b>	Interest rate, foreign exchange, credit spread
Loans and receivables:					
Loans and advances to banks	<b>26,902</b>	–	<b>5,583</b>	<b>21,319</b>	Interest rate
Loans and advances to customers <sup>1</sup>	<b>457,958</b>	–	<b>457,958</b>	–	Interest rate
Debt securities	<b>3,397</b>	–	<b>3,397</b>	–	Interest rate, credit spread
	<b>488,257</b>	–	<b>466,938</b>	<b>21,319</b>	
Available-for-sale financial assets	<b>56,524</b>	–	<b>56,522</b>	<b>2</b>	Interest rate, foreign exchange, credit spread
Value of in-force business	<b>5,042</b>	–	–	<b>5,042</b>	Equity
Other assets	<b>33,206</b>	–	<b>16,811</b>	<b>16,395</b>	Interest rate
Total assets	<b>817,793</b>	<b>76,198</b>	<b>594,475</b>	<b>147,120</b>	
Liabilities					
Deposits from banks	<b>16,384</b>	–	<b>16,384</b>	–	Interest rate
Customer deposits	<b>415,460</b>	–	<b>415,460</b>	–	Interest rate
Trading and other financial liabilities at fair value through profit or loss	<b>54,504</b>	<b>45,079</b>	<b>9,425</b>	–	Interest rate, foreign exchange
Derivative financial instruments	<b>34,924</b>	<b>30,143</b>	<b>1,967</b>	<b>2,814</b>	Interest rate, foreign exchange, credit spread
Debt securities in issue	<b>76,314</b>	–	<b>76,314</b>	–	Interest rate, credit spread
Liabilities arising from insurance and investment contracts	<b>114,502</b>	–	–	<b>114,502</b>	Credit spread
Subordinated liabilities	<b>19,831</b>	–	<b>18,012</b>	<b>1,819</b>	Interest rate, foreign exchange
Other liabilities	<b>37,409</b>	–	<b>9,726</b>	<b>27,683</b>	Interest rate
Total liabilities	<b>769,328</b>	<b>75,222</b>	<b>547,288</b>	<b>146,818</b>	

<sup>1</sup> Includes £6.7 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 36 on page F-47 provides further information.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group's trading book assets and liabilities are originated by Financial 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 92.

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 Financial 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-38).

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 the Funding and Liquidity Risk on page 95. 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.

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 (page 89).

Table 1.34 shows the key material market risks for the Group's banking, defined benefit pension schemes, Insurance and trading activities.

**Table 1.34: Key material market risks for the Group by individual business activity (profit before tax impact measured against Group single stress scenarios)**

2016	Risk type					
	Interest Rate	Basis Risk	FX	Credit Spread	Equity	Inflation
Banking activities <sup>1</sup>	1	1	-	1	1	-
Defined benefit pension scheme <sup>1</sup>	1	-	-	n	-	-
Insurance portfolios <sup>1</sup>	1	-	-	1	1	-
Trading portfolios <sup>2</sup>	-	-	-	-	-	-
Profit before tax		Loss	Gain			
>£500m		1	n			
£250m – £500m		1	n			
£50m – <£250m		1	n			
Immaterial/zero		-	-			

Banking Activities: Insurance and Pensions stresses; Interest rate -100 bps, Basis 3 month Libor +100bps/Bank Base 1 Rate -25pbs, FX -15 per cent GBP.

Credit Spread +100 per cent, Equity -30 per cent, Inflation +50 bps.

<sup>2</sup>Trading Portfolios; Interest rate -30bps, FX -5 per cent GBP, Credit spread +20 per cent, Inflation +30bps.

## MEASUREMENT

In addition to measuring single factors, board risk appetite is calibrated primarily to five economic multirisk 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 Board 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 Division 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.

88

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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*

Interest rate 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 1.36) and off balance sheet positions. Behavioural assumptions are applied to (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) to the re-pricing behaviour of managed rate liabilities namely variable rate savings.

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.

Prepayment risk arises, predominantly in the Retail division, as customer balances amortise more quickly or slowly than anticipated due to economic conditions or customer's response to changes in economic conditions. Pipeline and pre hedge risk arises where new business volumes are higher or lower than forecasted.

*Foreign exchange risk*

Economic foreign exchange exposure arises from the Group's investment in its overseas operations (net investment exposures are disclosed in note 52 on page F-87). 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; and (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 it 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).

(ii) Interest income sensitivity: this measures the impact on future net interest income arising from an instantaneous 25, 100 and 200 basis points parallel rise or fall in all the yield curves over a rolling 12 month basis (subject to an appropriate floor). 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 such change.

(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 to ensure the assumptions remain appropriate.

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 1.35 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 1.35: **Banking activities: market value sensitivity**

	2016				2015			
	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	(11.4)	11.5	(45.1 )	31.6	48.7	(48.8 )	194.2	(115.9 )
US Dollar	3.2	(3.2 )	12.6	(13.7 )	1.9	(1.9 )	7.5	(5.9 )
Euro	(6.0 )	(3.7 )	(23.2 )	(12.1 )	1.7	(2.1 )	6.9	(6.8 )
Other	(0.2 )	0.2	(0.9 )	0.6	(0.4 )	0.4	(1.6 )	1.1
Total	(14.4)	4.8	(56.6 )	6.4	51.9	(52.4 )	207.0	(127.5 )

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 1.36 below shows supplementary value sensitivity to a steepening and flattening in the yield curve. This ensures there are no unintended consequences to managing risk to parallel shifts in rates.

Table 1.36: **Banking activities: market value sensitivity to a steepening and flattening of the yield curve**

	2016		2015	
	Steepener £m	Flattener £m	Steepener £m	Flattener £m
Sterling	(5.8 )	(13.2 )	(105.7)	97.1
US Dollar	0.7	(1.3 )	(3.4 )	4.8
Euro	(15.3)	(12.8 )	(0.5 )	2.0
Other	(0.2 )	0.2	0.2	(0.2 )
Total	(20.6)	(27.1 )	(109.4)	103.7

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 1.37: **Banking activities: net interest income sensitivity (audited)**

	2016				2015			
	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Client facing activity and associated hedges	176.8	(286.1)	724.9	(408.0 )	152.4	(140.1)	604.7	(464.2 )

Income sensitivity is measured over a rolling 12 month basis.

The interest income sensitivity continues to reflect structural hedging against margin compression. The increased sensitivity reflects both the timing of margin management, and the level of floors giving rise to increased compression risk in the Group.

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 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 Financial 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 amount and duration of the hedging activity is reviewed regularly by GALCO, with current maximum duration of around four years.

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 ALCOs.

Net investment foreign exchange exposures are managed centrally by GCT, by hedging non GBP asset values with currency borrowing. 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.

For further information on defined benefit pension scheme assets and liabilities please refer to note 36 on page F-47.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*MEASUREMENT*

Management of the 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.

*MITIGATION*

The Group takes an active involvement in agreeing risk management and mitigation strategies with the schemes' Trustees. An interest rate and inflation hedging programme is in place to reduce liability risk. In recent years the schemes have also reduced equity allocation and invested the proceeds in credit assets as part of a programme to de-risk the portfolio.

*MONITORING*

In addition to the wider risk management framework, governance of the schemes includes two specialist pensions committees (one Group executive sub-committee and a supporting management committee).

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. The impact on Group capital resources of the schemes is monitored monthly. Performance against risk appetite triggers is also monitored monthly. Hedges are in place and asset/liability matching positions are also actively monitored.

**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-38). 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 Insurance have 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 1.38 demonstrates the impact of the Group's UK Recession stress scenario (with no diversification benefit) on Insurance's portfolio; 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 1.38: **Insurance business: profit before tax sensitivities**

**Increase  
(reduction)  
in  
profit before**

**tax**

	<b>2016</b>	2015 <sup>1</sup>
	<b>£m</b>	£m
Interest rates – decrease 100 basis points	<b>(142)</b>	9
Inflation – increase 50 basis points	<b>(34 )</b>	(23 )
Credit spreads – 100% widening	<b>(812)</b>	(864 )
Equity – 30% fall	<b>(681)</b>	(616 )
Property – 25% fall	<b>(58 )</b>	(51 )

<sup>1</sup> Restated. The most onerous scenario has changed to UK Recession from Fiscal Solvency.

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 33.

*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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### *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/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 the Group does not have a programme of 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 (diversified across risk factors) was £1.3 million for year end 2016 compared to £1.4 million for year end 2015. This decrease was due to the significant de-risking activities that took place at the portfolio level.

Trading market risk measures are applied to all the Group's regulatory trading books and they include daily VaR (table 1.39), sensitivity based measures, and stress testing calculations.

#### *MEASUREMENT*

The Group internally uses VaR as the primary risk measure for all trading book positions.

Table 1.39 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 2016 and year end 2015.

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 1.39: **Trading portfolios: VaR (1-day 95 per cent confidence level) (audited)**

	At 31 December 2016				At 31 December 2015			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	0.7	1.3	7.7	0.5	0.8	1.4	3.5	0.8
Foreign exchange risk	0.1	0.3	0.8	0.1	0.2	0.3	0.8	0.1
Equity risk	–	–	–	–	–	–	–	–
Credit spread risk	0.2	0.2	0.4	0.1	0.2	0.4	1.0	0.2
Inflation risk	0.2	0.3	5.9	0.1	0.1	0.3	1.6	0.1
All risk factors before diversification	1.2	2.1	14.3	1.1	1.3	2.3	6.2	1.3
Portfolio diversification	(0.5)	(0.8)			(0.4)	(0.9)		
<b>Total VaR</b>	<b>0.7</b>	<b>1.3</b>	<b>5.7</b>	<b>0.6</b>	<b>0.9</b>	<b>1.4</b>	<b>3.1</b>	<b>0.8</b>

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. Note that the maximum VaR reported at £5.7 million was due to the incomplete booking of a position by end of day 22 March 2016 and hence did not reflect the true end of day position and was not a real limit breach. The VaR returned to normal levels once the booking was completed the next day. The next highest VaR was £3.8 million.

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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.

The aim of operational risk management is to manage operational risks, protecting customers and the Group, whilst delivering sustainable growth. Operational risks are managed in line with defined appetites through the Group Operational Risk Management Framework, evaluating key exposures, measuring risks, mitigating risks, and monitoring risks on an ongoing basis, as set out below.

**EXPOSURES**

The principal operational risks to the Group are:

-The risk that the Group is unable to provide services to customers as a result of an IT systems failure;

-Cyber risks associated with malicious attacks on the confidentiality or integrity of electronic data, or the availability of systems;

-Fraud and financial crime arising from acts of deception or omission;

-Ensuring compliance with increasingly complex and detailed anti-money laundering, anti-terrorism, sanctions and prohibitions laws and regulations, as failure to do so would adversely impact the Group's reputation and potentially incur fines and other legal enforcements;

-Risks arising from inadequate delivery of services to customers;

-The risk associated with the ongoing provision of services to TSB and other organisations; and

-Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events.

A number of these risks also apply where there is a reliance on third party suppliers to provide services to the Group or its customers.

## MEASUREMENT

Operational risk is managed within a Board approved framework and risk appetite. A variety of measures are used such as: scoring of potential risks, using impact and likelihood, with impact thresholds aligned to risk appetite statements; assessment of the effectiveness of controls; monitoring of events and losses by size, business unit and internal risk categories.

Table 1.40 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 2016, the highest frequency of events occurred in external fraud (61.58 per cent) and execution, delivery and process management (24.80 per cent). Clients, products and business practices accounted for 77.62 per cent of losses by value, driven by legacy issues where impacts materialised in 2016 (excluding PPI).

Table 1.40: Operational risk events by risk category (losses greater than or equal to £10,000), excluding PPI

	% of total volume		% of total losses	
	2016	2015	2016	2015
Business disruption and system failures	<b>1.01</b>	0.40	<b>0.55</b>	0.13
Clients, products and business practices	<b>11.31</b>	11.46	<b>77.62</b>	83.43
Damage to physical assets	<b>1.05</b>	0.06	<b>0.27</b>	0.04
Employee practices and workplace safety	<b>0.04</b>	0.03	–	–
Execution, delivery and process management	<b>24.80</b>	15.81	<b>19.23</b>	11.08
External fraud	<b>61.58</b>	71.96	<b>2.31</b>	5.27
Internal fraud	<b>0.21</b>	0.28	<b>0.02</b>	0.05
<b>Total</b>	<b>100.00</b>	100.00	<b>100.00</b>	100.00

Operational risk scenario assessments and actual losses are used by the Group to calculate the appropriate holding of operational risk regulatory capital under the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its minimum (Pillar I) operational risk capital requirements using The Standardised Approach (TSA), which the Basel Committee has stated as being appropriate for an 'internationally active' bank.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### MITIGATION

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. This ensures the correct level of visibility and engagement. The Group employs a range of risk management strategies, including: avoidance, mitigation, transfer (which would also include 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 sourcing process including due diligence and risk evaluation. Contingency plans are maintained for a range of potential scenarios, with regular disaster recovery and scenario testing scheduled to test and challenge the readiness of the Group to respond in the event of an incident.

The Group continues to mature its approach to operational resilience by enhancing the resilience of systems that support the Group's critical business processes through the IT 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 its resilience.

The threat landscape associated with cyber risk continues to evolve and regulatory attention continues. The Board has defined a Cyber Risk Appetite and is supporting initiatives to protect the Group against malicious cyber-attacks. The Group continues to invest in enhanced protection of customer information, including limiting access to key systems and enhancing the security, durability and accessibility of critical information.

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 term 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 has adopted policies and procedures designed to detect and prevent the use of its banking network for money laundering, terrorist financing, bribery and activities prohibited by legal and regulatory sanctions. The Group regularly reviews and assesses these policies to keep them current, effective and consistent across markets and jurisdictions, against a background of increasingly complex and detailed laws and regulations. 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 and reporting of suspicions of money laundering or terrorist financing to the applicable regulatory authorities and 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.

The Group remediates issues that are identified in its customer processes, addressing root cause and rectifying customers as required. Enhancing the overall servicing environment remains a focus of dedicated Group programmes such as Customer Journey Transformation.

Following the successful divestment of TSB the Group retains responsibility for the ongoing provision of key services which are managed via robust service and change management processes. There are separate governance arrangements and additional controls in place to ensure contractual commitments are met.

Operational resilience measures and recovery planning defined in the Group's Resilience & 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.

## MONITORING

Monitoring and reporting is undertaken at Board, Group and business area committees, in accordance with delegated limits of authority which are regularly reviewed and refreshed. Business unit risk exposure is aggregated and discussed at oversight committees, and matters are escalated to the Chief Risk Officer, or higher committees, if appropriate. A combination of: regular management information and reporting from business areas, oversight and challenge from Risk Division, Group Audit and other assurance activities ensures that key risks are regularly presented and debated by executive management.

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

**EXPOSURE**

Liquidity exposure represents the amount of potential stressed outflows in any future period less expected inflows. Liquidity is considered 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 maturity. Note 52 on page F-87 sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. Divisional teams form a view of customer behaviour based on quantitative and qualitative analysis.

**MITIGATION**

The Group manages the liquidity profile of the balance sheet through short term liquidity management and over the life of the funding plan, combining business as usual and stressed conditions. Longer term funding, defined as having an original maturity of more than one year, is used to manage the Group's strategic liquidity profile, determined by the Group's balance sheet structure.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and is supported by strong relationships with corporate customers and certain wholesale market segments. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although mostly repayable on demand, have traditionally in aggregate provided a stable source of funding. Funding concentration by counterparty and currency is monitored on an ongoing basis. Where concentrations do exist (for example, maturity profile), these are limited by the internal risk appetite and considered manageable. The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's Banking businesses.

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 in a manner consistent with the Group Funding and Liquidity Policy; helps drive the correct inputs to customer pricing and supports the overall Group balance sheet strategy; 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 data gathered over several years.

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**

Liquidity is actively monitored at Group level. Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. Liquidity policies and procedures are subject to independent internal oversight by Risk.

The Group carries out stress testing of its liquidity and potential cash flow mismatch position over both short (up to one month) and longer term (up to three months) horizons against a range of scenarios. The scenarios and the assumptions are reviewed at least annually to gain assurance that they continue to be relevant to the nature of the business. For further information on the Group's 2016 liquidity stress testing results refer to page 98. The Group funding plan is also stressed against a range of macroeconomic scenarios. Regulatory metrics are calculated and monitored over the life the plan under base and stress conditions.

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 2016**

During 2016 the Group has maintained its strong funding and liquidity position, with a loan to deposit ratio of 108.9 per cent.

Total funded assets reduced by £5.8 billion to £465.4 billion during 2016. Loans and advances to customers, excluding reverse repos, reduced by £5.5 billion. Growth in Consumer Finance was strong at 11 per cent and SME lending growth was 3 per cent, both outperforming the market. This was offset by a reduction in mortgage balances as the Group continues to balance risk and margin considerations versus volumes in a competitive low growth market. Total customer deposits fell by £5.3 billion to £413.0 billion at 31 December 2016, largely due to lower Retail and Consumer Finance tactical balances.

Wholesale funding has decreased by £9.1 billion to £110.8 billion as excess liquidity is managed down; the amount with a residual maturity less than one year fell to £35.1 billion (£37.9 billion at 31 December 2015). The Group's term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) is unchanged at 68 per cent. During 2016 the Group's term issuance costs have remained broadly in line with other post-crisis years and significantly lower than levels seen during the economic downturn. The Group's overall cost of wholesale funding has reduced



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

as more expensive funding raised in previous years mature. The Group's market capacity for term funding is considered across the planning horizon as part of the funding plan and the Group expects term funding requirements to remain stable.

The credit ratings on Lloyds Bank were unchanged over 2016, and the median credit rating among the three major credit rating agencies remains 'A+'. Following the EU referendum in June, both S&P and Moody's revised their outlooks on Lloyds Bank, among other UK banks, in order to reflect increased macroeconomic uncertainty. S&P revised the outlook on Lloyds Bank's 'A' rating to 'Negative' from 'Stable' whilst Moody's revised the outlook on Lloyds Bank's 'A1' rating to 'Stable' from 'Positive'. Moody's also revised their outlook on the UK banking system to 'Negative' from 'Stable'. Fitch's outlook on Lloyds Bank's 'A+' rating remained 'Stable' as Fitch expect the economic effects of the referendum to be manageable. The effects of a potential downgrade from all three credit rating agencies are included in Group liquidity stress testing.

The LCR became the Pillar 1 standard for liquidity in the UK in October 2015. The Group comfortably meets the requirements. Liquid asset holdings have fallen during the second half of 2016 as excess liquidity held during the EU Referendum is managed down. The Group continues to monitor the Net Stable Funding Ratio (NSFR) requirements and expects to meet them once confirmed by the PRA.

Table 1.41: Group funding position

	At 31 Dec 2016 £bn	At 31 Dec 2015 £bn	Change %
<b>Funding requirement</b>			
Loans and advances to customers <sup>1</sup>	449.7	455.2	(1 )
Loans and advances to banks <sup>2</sup>	5.1	3.4	50
Debt securities	3.4	4.2	(19 )
Reverse repurchase agreements	0.5	1.0	(50 )
Available-for-sale financial assets – non-LCR eligible <sup>3</sup>	1.9	2.7	(30 )
Cash and balances at central bank – non LCR eligible <sup>4</sup>	4.8	4.7	2
<b>Funded assets</b>	<b>465.4</b>	<b>471.2</b>	<b>(1 )</b>
Other assets <sup>5</sup>	249.9	234.2	7
	715.3	705.4	1
<b>On balance sheet LCR eligible liquidity assets</b>			
Reverse repurchase agreements	8.7	–	
Cash and balances at central banks <sup>4</sup>	42.7	53.7	(20 )
Available-for-sale financial assets <sup>6</sup>	54.6	30.3	80
Held-to-maturity financial assets <sup>6</sup>	–	19.8	
Trading and fair value through profit and loss	1.8	3.0	(40 )

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Repurchase agreements	(5.3 )	(5.5 )	(4 )
	<b>102.5</b>	101.3	1
<b>Total Group assets</b>	<b>817.8</b>	806.7	1
Less: other liabilities <sup>5</sup>	(245.5 )	(221.5 )	11
<b>Funding requirement</b>	<b>572.3</b>	585.2	(2 )
<b>Funded by</b>			
Customer deposits <sup>7</sup>	<b>413.0</b>	418.3	(1 )
Wholesale funding <sup>8</sup>	<b>110.8</b>	119.9	(8 )
	<b>523.8</b>	538.2	(3 )
Repurchase agreements	–	–	
Total equity	<b>48.5</b>	47.0	4
<b>Total funding</b>	<b>572.3</b>	585.2	(2 )

1 Excludes £8.3 billion (31 December 2015: £nil) of reverse repurchase agreements.

2 Excludes £20.9 billion (31 December 2015: £20.8 billion) of loans and advances to banks within the Insurance business and £0.9 billion (31 December 2015: £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.

5 Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

The Group reclassified gilts held within the liquidity portfolio as 'available-for-sale' (previously been classified as 'held-to-maturity') during the third quarter of 2016 as the Group has decided it is no longer appropriate to commit to holding any gilts to maturity.

7 Excludes £2.5 billion (31 December 2015: £nil) of repurchase agreements.

8 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.42: Reconciliation of Group funding to the balance sheet (audited)

	At 31 December 2016				At 31 December 2015			
	Repos and cash included in funding analysis		Fair value and other accounting methods	Balance sheet	Repos and cash included in funding analysis		Fair value and other accounting methods	Balance sheet
	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Deposits from banks	8.1	8.0	0.3	16.4	8.5	8.4	–	16.9
Debt securities in issue	83.0	–	(6.7)	76.3	88.1	–	(6.0)	82.1
Subordinated liabilities	19.7	–	0.1	19.8	23.3	–	–	23.3
<b>Total wholesale funding</b>	<b>110.8</b>	<b>8.0</b>			119.9	8.4		
Customer deposits	413.0	2.5	–	415.5	418.3	–	–	418.3
<b>Total</b>	<b>523.8</b>	<b>10.5</b>			538.2	8.4		

Table 1.43: Analysis of 2016 total wholesale funding by residual maturity

	One to three months		Three to six months	Six to nine months	Nine months to one year	One to two years	Two to five years	More than five years	Total at 31 Dec 2016	Total at 31 Dec 2015
	£bn	£bn							£bn	£bn
Deposit from banks	6.1	1.0	0.5	0.4	–	0.1	–	–	8.1	8.5
Debt securities in issue:										
Certificates of deposit	0.4	2.1	3.0	1.7	0.3	–	–	–	7.5	10.6
Commercial paper	2.0	0.8	–	0.4	–	–	–	–	3.2	6.6
Medium-term notes <sup>1</sup>	–	1.5	2.7	1.4	0.3	5.1	12.3	13.6	36.9	37.6
Covered bonds	2.1	2.8	1.1	–	–	2.2	10.7	10.2	29.1	25.8
Securitisation	0.6	1.0	0.4	0.7	0.8	0.7	1.8	0.3	6.3	7.5
Subordinated liabilities	5.1	8.2	7.2	4.2	1.4	8.0	24.8	24.1	83.0	88.1
<b>Total wholesale funding<sup>2</sup></b>	<b>11.2</b>	<b>9.7</b>	<b>7.8</b>	<b>5.0</b>	<b>1.4</b>	<b>10.5</b>	<b>28.5</b>	<b>36.7</b>	<b>110.8</b>	<b>119.9</b>
<b>Of which issued by Lloyds Banking Group plc<sup>3</sup></b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>1.7</b>	<b>5.7</b>	<b>7.4</b>	<b>3.4</b>

<sup>1</sup> Medium-term notes include funding from the National Loan Guarantee Scheme (31 December 2016: £1.4 billion; 31 December 2015: £1.4 billion).

<sup>2</sup> The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

<sup>3</sup> Consists of medium-term notes (£2.5 billion) and subordinated liabilities (£4.9 billion).

Table 1.44: **Total wholesale funding by currency (audited)**

	<b>Sterling</b>	<b>US Dollar</b>	<b>Euro</b>	<b>Other</b>	<b>Total</b>
	<b>£bn</b>	<b>£bn</b>	<b>£bn</b>	<b>currencies</b>	<b>£bn</b>
				<b>£bn</b>	
<b>At 31 December 2016</b>	<b>30.6</b>	<b>33.0</b>	<b>41.4</b>	<b>5.8</b>	<b>110.8</b>
At 31 December 2015	34.9	37.6	41.3	6.1	119.9

Table 1.45: **Analysis of 2016 term issuance (audited)**

	<b>Sterling</b>	<b>US Dollar</b>	<b>Euro</b>	<b>Other</b>	<b>Total</b>
	<b>£bn</b>	<b>£bn</b>	<b>£bn</b>	<b>currencies</b>	<b>£bn</b>
				<b>£bn</b>	
Securitisation	<b>0.3</b>	<b>0.4</b>	–	–	<b>0.7</b>
Medium-term notes	–	<b>1.5</b>	<b>1.2</b>	<b>0.4</b>	<b>3.1</b>
Covered bonds	<b>1.2</b>	–	<b>2.4</b>	–	<b>3.6</b>
Private placements <sup>1</sup>	<b>0.1</b>	<b>1.0</b>	<b>0.8</b>	–	<b>1.9</b>
Subordinated liabilities	–	<b>1.1</b>	–	–	<b>1.1</b>
<b>Total issuance</b>	<b>1.6</b>	<b>4.0</b>	<b>4.4</b>	<b>0.4</b>	<b>10.4</b>
<b>Of which issued by Lloyds Banking Group plc<sup>2</sup></b>	–	<b>3.8</b>	<b>1.2</b>	<b>0.4</b>	<b>5.4</b>

<sup>1</sup> Private placements include structured bonds and term repurchase agreements (repos).

<sup>2</sup> Consists of medium-term notes (£2.5 billion) and subordinated liabilities (£3.0 billion).

Gross term issuance for 2016 totalled £10.4 billion. The Group maintained 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. In 2016, the Group drew down £1.0 billion under the Funding for Lending Scheme (FLS), taking peak usage to £33.1 billion, with £3.0 billion of maturities during the year. A further £4.5 billion was drawn under the Bank of England's Term Funding Scheme (TFS), underlining the Group's support to the UK economy. The maturities for the FLS and TFS are fully factored into the Group's funding plan.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LIQUIDITY PORTFOLIO

At 31 December 2016, the Banking business had £120.8 billion of highly liquid unencumbered LCR eligible assets, of which £120.3 billion is LCR level 1 eligible and £0.5 billion is LCR level 2 eligible. 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 8 times the Group's money market funding less than one year maturity (excluding derivative collateral margins and settlement accounts) and exceed total wholesale funding, and thus provides a substantial buffer in the event of continued market dislocation.

Table 1.46: LCR eligible assets

	<b>At 31 Dec 2016 £bn</b>	At 31 Dec 2015 £bn	Change %	<b>Average 2016 £bn</b>	Average <sup>1</sup> 2015 £bn
<b>Level 1</b>					
Cash and central bank reserves	<b>42.7</b>	53.7	(20 )	<b>53.7</b>	57.2
High quality government/MDB/agency bonds <sup>2</sup>	<b>75.3</b>	65.8	14	<b>72.4</b>	63.0
High quality covered bonds	<b>2.3</b>	3.4	(32 )	<b>2.4</b>	3.3
Total	<b>120.3</b>	122.9	(2 )	<b>128.5</b>	123.5
Level 2 <sup>3</sup>	<b>0.5</b>	0.5	–	<b>0.5</b>	0.7
<b>Total LCR eligible assets</b>	<b>120.8</b>	123.4	(2 )	<b>129.0</b>	124.2

1 Average for 2015 includes fourth quarter 2015 only.

2 Designated multilateral development bank (MDB).

3 Includes Level 2A and Level 2B.

Table 1.47: LCR eligible assets by currency

	<b>Sterling £bn</b>	<b>US Dollar £bn</b>	<b>Euro £bn</b>	<b>Other currencies £bn</b>	<b>Total £bn</b>
<b>At 31 December 2016</b>					
Level 1	<b>96.0</b>	<b>12.5</b>	<b>11.8</b>	–	<b>120.3</b>
Level 2	<b>0.2</b>	<b>0.3</b>	–	–	<b>0.5</b>
<b>Total</b>	<b>96.2</b>	<b>12.8</b>	<b>11.8</b>	–	<b>120.8</b>
At 31 December 2015					
Level 1	90.9	15.8	16.2	–	122.9

## Edgar Filing: Lloyds Banking Group plc - Form 20-F

Level 2	0.1	–	0.4	–	0.5
Total	91.0	15.8	16.6	–	123.4

The Banking business also had £113.8 billion of secondary, non-LCR eligible liquidity, the vast majority of which is eligible for use in a range of central bank or similar facilities and the Group routinely makes use of as part of its normal liquidity management practices. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

The Group considers diversification across geography, currency, markets and tenor when assessing appropriate holdings of liquid assets. This liquidity is managed as a single pool in the centre and is under the control of the function charged with managing the liquidity of the Group. It is available for deployment at immediate notice, subject to complying with regulatory requirements.

### **STRESS TESTING RESULTS**

Internal stress testing results at 31 December 2016 showed that the Banking business had liquidity resources representing 167.0 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 £3.1 billion of cash over a period of up to one year, £1.8 billion of collateral posting related to customer financial contracts and £9.0 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.

The Group's analysis separately identifies those assets held at central banks; assets not held at central banks are classified as either encumbered or unencumbered.

The Board and GALCO monitor and manage total balance sheet encumbrance via a number of risk appetite metrics. At 31 December 2016, the Group had £83.5 billion (31 December 2015: £77.4 billion) of externally encumbered on balance sheet assets with counterparties other than central banks. The increase in encumbered assets was driven by an increase in the use of on balance sheet available-for-sale financial assets for repo activity. The Group also had £580.9 billion (31 December 2015: £573.7 billion) of unencumbered on balance sheet assets, and £153.5 billion (31 December 2015: £155.6 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.48: On balance sheet encumbered and unencumbered assets

	Encumbered with counterparties other than central banks			Total	Pre-positioned and encumbered assets held with central banks	Unencumbered assets not pre-positioned with central banks			Total	Total
	Securitisations	Covered	Other			Readily realisable	Other realisable	Cannot be used <sup>1</sup>		
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
<b>At 31 December 2016</b>										
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
Held-to-maturity investments	–	–	–	–	–	–	–	–	–	–
Other <sup>2</sup>	–	–	–	–	–	34	1,737	36,477	38,248	38,248
<b>Total assets</b>	<b>14,696</b>	<b>30,883</b>	<b>37,871</b>	<b>83,450</b>	<b>153,482</b>	<b>93,128</b>	<b>156,617</b>	<b>331,116</b>	<b>580,861</b>	<b>817,793</b>
<b>At 31 December 2015</b>										
Cash and balances at	–	–	–	–	–	56,323	–	2,094	58,417	58,417



central banks										
Trading and other financial assets at fair value through profit or loss	–	–	6,922	6,922	–	7,459	17	126,138	133,614	140,536
Derivative financial instruments	–	–	–	–	–	–	–	29,467	29,467	29,467
Loans and receivables:										
Loans and advances to banks	–	–	37	37	–	431	910	23,739	25,080	25,117
Loans and advances to customers	13,668	32,641	7,418	53,727	150,086	7,678	159,510	84,174	251,362	455,175
Debt securities	–	–	855	855	–	3,150	62	124	3,336	4,191
	13,668	32,641	8,310	54,619	150,086	11,259	160,482	108,037	279,778	484,483
Available-for-sale financial assets	–	–	15,810	15,810	5,548	11,048	31	595	11,674	33,032
Held-to-maturity investments	–	–	–	–	–	19,808	–	–	19,808	19,808
Other <sup>2</sup>	–	–	–	–	–	10	2,716	38,219	40,945	40,945
Total assets	13,668	32,641	31,042	77,351	155,634	105,907	163,246	304,550	573,703	806,688

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 1 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.

Other comprises: items in the course of collection from banks, investment properties, goodwill, value in-force 2business, other tangible 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*CONTRACTUAL CASH OBLIGATIONS*

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2016.

	<b>Within one year £m</b>	<b>One to three years £m</b>	<b>Three to five years £m</b>	<b>Over five years £m</b>	<b>Total £m</b>
Long-term debt – dated	761	2,195	3,446	7,832	14,234
Debt securities in issue	25,708	14,914	18,655	26,460	85,737
Finance leases	8	3	–	12	23
Operating leases	264	453	402	944	2,063
Capital commitments	543	–	–	–	543
Other purchase obligations	1,221	1,899	912	557	4,589
	<b>28,505</b>	<b>19,464</b>	<b>23,415</b>	<b>35,805</b>	<b>107,189</b>

Other purchase obligations include amounts expected to be payable in respect of material contracts entered into by the Lloyds Banking Group, in the ordinary course of business, for the provision of outsourced and other services. The cost of these services will be charged to the income statement as it is incurred. The Lloyds Banking Group also has a constructive obligation to ensure that its defined post-retirement benefit schemes remain adequately funded. The amount and timing of the Lloyds Banking Group's cash contributions to these schemes is uncertain and will be affected by factors such as future investment returns and demographic changes. Lloyds Banking Group expects to make cash contributions of at least £575 million to these schemes in 2017.

At 31 December 2016, Lloyds Banking Group also had £5,597 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2016, 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 2016 is included in note 52 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 £6,883 million at 31 December 2016 (with £3,815 million expiring within one year; £667 million between one and three years; £1,334 million between three and five years; and £1,067 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 2016, 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 19 and 20 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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 is needed 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 holds using the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA). Full details of the Group's regulatory capital and leverage frameworks 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 2 of the regulatory framework and a number of regulatory capital buffers as described below.

Additional minimum requirements are set by the PRA by 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. It includes the assessment of 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).

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.

There are three systemic buffers in the Capital Requirements Directive:

The G-SII buffer is applied to global systemically important institutions. The Group has not been classified as a G-SII.

The O-SII buffer may be applied to other systemically important institutions. The Group has been classified as an O-SII by the PRA, but the O-SII buffer is set to zero in the UK.

The Systemic Risk Buffer (SRB) will be applied to ring-fenced banks from 1 January 2019. In July 2016 the FPC published their methodology for quantifying the buffer for each ring-fenced bank and in December 2016 the PRA published their statement of policy on their approach for implementing the SRB. 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 largest buffer the FPC anticipates applying to any ring-fenced bank is 2.5 per cent.

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 PRA Buffer that applies to the Group 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 RWAs 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 2016 it was 0.625 per cent and during 2017 it is 1.25 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 buffer is currently set at zero for the UK, however non-zero rates for Norway, Sweden and Hong Kong

were in place at 31 December 2016. Given that the Group has minimal exposures to these jurisdictions, the overall requirement is negligible. The UK CCYB rate was set to increase from 0 per cent to 0.5 per cent of risk-weighted assets on 29 March 2017, at which time the overlapping aspects of Pillar 2 supervisory capital buffers would be removed or reduced. However, following the EU referendum, on 5 July 2016 the FPC announced in their Financial Stability Report that the planned 0.5 per cent UK CCYB would not be implemented in March 2017 and the zero per cent rate was expected to remain until at least June 2017. The FPC also recommended that where existing Pillar 2 supervisory buffers reflect risks that would be captured by a UK CCYB rate, the PRA should reduce those buffers by an amount of capital which is equivalent to the effect of a UK CCYB rate of 0.5 per cent. The FPC has also indicated that it expects to review the UK CCYB and to set a rate in the region of 1 per cent of risk-weighted assets when risks are judged to be neither subdued nor elevated, but the rate can be set in excess of this level. Any increase in CCYB would take effect 1 year after it is set.

The FPC can also set sectoral capital requirements which are temporary increases to banks' capital requirements on exposures to specific sectors, if the FPC judges that exuberant lending to those sectors poses risks to financial stability. No sectoral capital requirements currently apply to the Group.

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 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, CCYB and any sectoral capital requirements that already apply to the Group. 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

In addition to the risk-based capital framework outlined above, the Group is also subject to minimum capital requirements under the UK's 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 in the UK is 3 per cent, in line with current Basel requirements. In addition the UK 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 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 regulatory ratios are 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 strategy 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 the minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

### **Target capital ratios**

The Board's view of the current level of CET1 capital required to grow the business, meet regulatory requirements and cover uncertainties and future regulatory developments remains at around 13 per cent.

This takes into account, amongst other things:

the Pillar 2A Individual Capital Guidance (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 a reduction from 4.6 per cent to 4.5 per cent of risk-weighted assets at 31 December 2016, of which 2.5 per cent has to be covered 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 and other information. In November 2016 the PRA published the results of its 2016 stress tests which showed the Group's capital depletion to be 2.5 per cent after management actions compared to 3.3 per cent in the 2015 PRA stress tests and 4.8 per cent in the 2014 PRA stress tests. The PRA requires the PRA buffer to remain confidential between the Group and the PRA.

future regulatory developments, including the introduction of the Systemic Risk Buffer in 2019.



In addition, the Group targets a transitional total capital ratio of around 20 per cent.

### **Dividend policy**

The Group has established a dividend policy that is both progressive and sustainable. Ordinary dividends are expected to increase over the medium term to a dividend payout ratio of at least 50 per cent of sustainable earnings. The Board interprets progressive to indicate a dividend per share that is expected to increase over the medium term. Sustainable earnings represents the long term earnings generation of the business. Sustainable earnings are defined as earnings after tax attributable to ordinary shareholders adjusted to remove the effects of market volatility, exceptional conduct or litigation events, major liability management or restructuring and other one off items such as the sale of businesses, and exceptional underlying business performance.

The Board also gives due consideration to the distribution of surplus capital through the use of special dividends or share buy-backs. Surplus capital represents capital over and above the amount management wish to retain 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 the Board will continue to give due consideration, subject to the situation at the time, to the distribution of any surplus capital. By its nature, there can be no guarantee that this level of special dividends or 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Distributable reserves are determined as required by the Companies Act 2006 by reference to a company's individual financial statements. At 31 December 2016 Lloyds Banking Group plc ('the Company') had accumulated distributable reserves of approximately £8,500 million. 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 2016, had a consolidated CET1 capital ratio of 15.1 per cent (31 December 2015: 15.2 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.

During 2016 the Group has continued to simplify the Group's internal capital structure and to ensure that profits generated by subsidiary entities can be more easily remitted to the Company. This included the court approved capital reduction by Lloyds Bank plc.

### **Analysis of capital position**

During 2016 the Group continued to strengthen its capital position with a fully loaded CET1 ratio, after accruing for foreseeable dividends, of 13.4 per cent and 13.7 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2017 in relation to its 2016 earnings (31 December 2015: 13.0 per cent on an adjusted basis). The accrual for foreseeable dividends includes both the recommended full year ordinary dividend of 2.55 pence per ordinary share and a special dividend of 0.5 pence per ordinary share.

The final and special dividends proposed were consistent with a CET1 ratio on an adjusted basis retaining circa 0.8 per cent of capital, above the current target level, to cover the estimated capital impact of the MBNA acquisition that was announced in December 2016. Subsequently, on 2 March 2017, the FCA provided further clarification in relation to the consultation paper dealing with PPI, resulting in an additional provision of £350 million being recorded, reducing the adjusted CET1 ratio by 18 bps to 13.7 per cent.

Over the year the Group generated around 1.7 per cent of CET1 capital on an adjusted basis, pre dividend, primarily as a result of the following:

- Strong underlying capital generation of 2.2 per cent, largely driven by underlying profits;
- The dividend paid by the Insurance business in February 2017 in relation to its 2016 earnings of 0.2 per cent;
- Impact of conduct charges of (1.2) per cent;

Impact of market movements, netting to 0.2 per cent. This included 0.8 per cent from the impact of the accounting reclassification of c.£20 billion of gilts within the liquidity portfolio from 'held-to-maturity' to 'available-for-sale', offset by a number of market related movements, including an adverse impact of movements in the defined benefit pension schemes of (0.4) per cent;

Other items largely representing a reduction in risk-weighted assets, most notably in the fourth quarter, 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 the impact of the redemption of the remaining series of Enhanced Capital Notes in the first quarter.

After accruing for foreseeable dividends, the transitional total capital ratio reduced by 0.3 percentage points to 21.2 per cent, primarily reflecting managed reductions in tier 2 capital, largely due to calls and redemptions, partially offset by the increase in CET1 capital and the reduction in risk-weighted assets.

In 2020 the Group will have to meet a Minimum Requirement for Own Funds and Eligible Liabilities (MREL). During 2016 the Group commenced issuance of senior unsecured securities from Lloyds Banking Group plc, which, while not included in total capital, are eligible to meet MREL, £2.5 billion (Sterling equivalent) was issued in 2016 and a further £2.2 billion (Sterling equivalent) was issued in January 2017 leaving the Group well positioned to meet MREL requirements from 2020.

The leverage ratio, after accruing for foreseeable dividends, was 4.8 per cent (4.9 per cent on an adjusted basis).

An analysis of the Group's capital position as at 31 December 2016 is presented in the following section applying CRD IV transitional arrangements and also on a fully loaded CRD IV basis, both as implemented in the UK by the PRA.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The table below summarises the consolidated capital position of the Group.

Table 1.49: Capital resources

	Transitional		Fully loaded	
	At 31 Dec 2016 £m	At 31 Dec 2015 <sup>1</sup> £m	At 31 Dec 2016 £m	At 31 Dec 2015 <sup>1</sup> £m
<b>Capital resources (audited)</b>				
<b>Common equity tier 1</b>				
Shareholders' equity per balance sheet	42,670	41,234	42,670	41,234
Adjustment to retained earnings for foreseeable dividends	(1,568 )	(1,427 )	(1,568 )	(1,427 )
Deconsolidation adjustments <sup>1</sup>	1,342	1,119	1,342	1,119
Adjustment for own credit	87	67	87	67
Cash flow hedging reserve	(2,136 )	(727 )	(2,136 )	(727 )
Other adjustments <sup>1</sup>	(276 )	(97 )	(276 )	(97 )
	<b>40,119</b>	<b>40,169</b>	<b>40,119</b>	<b>40,169</b>
<b>less: deductions from common equity tier 1</b>				
Goodwill and other intangible assets	(1,623 )	(1,719 )	(1,623 )	(1,719 )
Prudent valuation adjustment	(630 )	(372 )	(630 )	(372 )
Excess of expected losses over impairment provisions and value adjustments	(602 )	(270 )	(602 )	(270 )
Removal of defined benefit pension surplus	(267 )	(721 )	(267 )	(721 )
Securitisation deductions	(217 )	(169 )	(217 )	(169 )
Significant investments <sup>1</sup>	(4,317 )	(4,500 )	(4,317 )	(4,529 )
Deferred tax assets	(3,564 )	(3,874 )	(3,564 )	(3,884 )
<b>Common equity tier 1 capital</b>	<b>28,899</b>	<b>28,544</b>	<b>28,899</b>	<b>28,505</b>
<b>Additional tier 1</b>				
Other equity instruments	5,320	5,355	5,320	5,355
Preference shares and preferred securities <sup>2</sup>	4,998	4,728	–	–
Transitional limit and other adjustments	(1,692 )	(906 )	–	–
	<b>8,626</b>	<b>9,177</b>	<b>5,320</b>	<b>5,355</b>
<b>less: deductions from tier 1</b>				
Significant investments <sup>1</sup>	(1,329 )	(1,177 )	–	–
<b>Total tier 1 capital</b>	<b>36,196</b>	<b>36,544</b>	<b>34,219</b>	<b>33,860</b>
<b>Tier 2</b>				
Other subordinated liabilities <sup>2</sup>	14,833	18,584	14,833	18,584
Deconsolidation of instruments issued by insurance entities <sup>1</sup>	(1,810 )	(1,665 )	(1,810 )	(1,665 )
Adjustments for transitional limit and non-eligible instruments	1,351	(52 )	(1,694 )	(3,066 )
Amortisation and other adjustments	(3,447 )	(3,880 )	(3,597 )	(4,885 )
	<b>10,927</b>	<b>12,987</b>	<b>7,732</b>	<b>8,968</b>
Eligible provisions	186	221	186	221
<b>less: deductions from tier 2</b>				

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Significant investments <sup>1</sup>	(1,571 )	(1,756 )	(2,900 )	(2,933 )
<b>Total capital resources</b>	<b>45,738</b>	47,996	<b>39,237</b>	40,116
<b>Risk-weighted assets</b>	<b>215,446</b>	222,845	<b>215,446</b>	222,747
Common equity tier 1 capital ratio <sup>3</sup>	<b>13.4%</b>	12.8%	<b>13.4%</b>	12.8%
Tier 1 capital ratio	<b>16.8%</b>	16.4%	<b>15.9%</b>	15.2%
Total capital ratio	<b>21.2%</b>	21.5%	<b>18.2%</b>	18.0%

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. The presentation of the deconsolidation of the Group's insurance entities has been amended for 2016 with comparative figures restated accordingly.

<sup>2</sup> Preference shares, preferred securities and other subordinated liabilities are categorised as subordinated liabilities in the balance sheet.

The common equity tier 1 ratio is 13.7 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2017 in relation to its 2016 earnings (31 December 2015: 13.0 per cent on an adjusted basis).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The key differences between the transitional capital calculation as at 31 December 2016 and the fully loaded equivalent are as follows:

Capital securities that previously qualified as tier 1 or tier 2 capital, but do not fully qualify under CRD IV, can be included in tier 1 or tier 2 capital (as applicable) up to specified limits which reduce by 10 per cent per annum until 2022.

The significant investment deduction from additional tier 1 (AT1) will gradually transition to tier 2.

The movements in the transitional CET1, AT1, tier 2 and total capital positions in the period are provided below.

Table 1.50: **Movements in capital resources**

	Common Equity Tier 1 £m	Additional Tier 1 £m	Tier 2 £m	Total capital £m
At 31 December 2015	28,544	8,000	11,452	47,996
Profit attributable to ordinary shareholders <sup>1</sup>	<b>1,720</b>	–	–	<b>1,720</b>
Movement in foreseeable dividends <sup>2</sup>	<b>(141 )</b>	–	–	<b>(141 )</b>
Dividends paid out on ordinary shares during the year	<b>(2,014 )</b>	–	–	<b>(2,014 )</b>
Dividends in respect of 2015 earnings received from the insurance business <sup>1</sup>	<b>500</b>	–	–	<b>500</b>
Movement in treasury shares and employee share schemes	<b>134</b>	–	–	<b>134</b>
Pension movements:				
Removal of defined benefit pension surplus	<b>454</b>	–	–	<b>454</b>
Movement through other comprehensive income	<b>(954 )</b>	–	–	<b>(954 )</b>
Available-for-sale reserve	<b>1,197</b>	–	–	<b>1,197</b>
Prudent valuation adjustment	<b>(258 )</b>	–	–	<b>(258 )</b>
Deferred tax asset	<b>310</b>	–	–	<b>310</b>
Goodwill and other intangible assets	<b>96</b>	–	–	<b>96</b>
Excess of expected losses over impairment provisions and value adjustments	<b>(332 )</b>	–	–	<b>(332 )</b>
Significant investments	<b>183</b>	<b>(152 )</b>	<b>185</b>	<b>216</b>
Eligible provisions	–	–	<b>(35 )</b>	<b>(35 )</b>
Movements in subordinated debt:				
Repurchases, redemptions and other	–	<b>(551 )</b>	<b>(3,211 )</b>	<b>(3,762 )</b>
Issuances	–	–	<b>1,151</b>	<b>1,151</b>
Other movements	<b>(540 )</b>	–	–	<b>(540 )</b>
<b>At 31 December 2016</b>	<b>28,899</b>	<b>7,297</b>	<b>9,542</b>	<b>45,738</b>

<sup>1</sup> 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.

<sup>2</sup> Includes the accrual for the 2016 full year ordinary and special dividends and the reversal of the accrual for the 2015 full year ordinary and special dividends which were paid during the year.

CET1 capital resources have increased by £355 million in the year largely as a result of profit generation in the year, dividends received from the Insurance business and the favourable movement in the available-for-sale reserve following the accounting reclassification of gilts within the liquidity portfolio from held-to-maturity. These movements in CET 1 capital were partially offset by dividends paid out during the year, movements in the defined benefit pension schemes largely driven by the impact of credit spreads, an increase in the excess of expected losses over impairment provisions and value adjustments primarily as a result of the implementation of recently published EBA guidance restricting prudent valuation adjustments eligible for offset against expected losses, and the accrual of the full year ordinary and special dividends, representing returns to ordinary shareholders following strong capital generation.

AT1 capital resources have reduced by £703 million in the year, primarily reflecting the annual reduction in the transitional limit applied to grandfathered AT1 capital instruments and an increase in the significant investments deduction.

Tier 2 capital resources have reduced by £1,910 million in the year largely reflecting calls and redemptions, including the redemption of all remaining series of Enhanced Capital Notes (ECNs) under the Regulatory Call Right, and the amortisation of dated tier 2 instruments, partly offset by the issuance of a new dated tier 2 instrument, foreign exchange movements on subordinated debt, the transitioning of grandfathered AT1 instruments to tier 2 and a reduction in the significant investments deduction.

The redemption of the remaining series of ECNs followed the decision of the Court of Appeal in December 2015 that a Capital Disqualification Event (CDE) in relation to the ECNs had occurred. The Group subsequently exercised its option to redeem them in the first quarter of 2016. In June 2016 the UK Supreme Court confirmed the decision of the Court of Appeal.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.51: Risk-weighted assets

	At 31 Dec 2016 £m	At 31 Dec 2015 £m
Foundation Internal Ratings Based (IRB) Approach	<b>64,907</b>	68,990
Retail IRB Approach	<b>64,970</b>	63,912
Other IRB Approach	<b>17,788</b>	18,661
<b>IRB Approach</b>	<b>147,665</b>	151,563
Standardised (STA) Approach	<b>18,956</b>	20,443
<b>Credit risk</b>	<b>166,621</b>	172,006
Counterparty credit risk	<b>8,419</b>	7,981
Contributions to the default fund of a central counterparty	<b>340</b>	488
Credit valuation adjustment risk	<b>864</b>	1,684
Operational risk	<b>25,292</b>	26,123
Market risk	<b>3,147</b>	3,775
<b>Underlying risk-weighted assets</b>	<b>204,683</b>	212,057
Threshold risk-weighted assets <sup>1</sup>	<b>10,763</b>	10,788
<b>Total risk-weighted assets</b>	<b>215,446</b>	222,845
Movement to fully loaded risk-weighted assets <sup>2</sup>	–	(98 )
<b>Fully loaded risk-weighted assets</b>	<b>215,446</b>	222,747

Threshold risk-weighted assets reflect the element of the significant investments and deferred tax assets that are permitted to be risk-weighted instead of deducted from CET1 capital. Significant investments primarily arise from the investment in the Group's Insurance business.

Differences may arise between transitional and fully loaded threshold risk-weighted assets where deferred tax assets<sup>2</sup> reliant on future profitability and arising from temporary timing differences and significant investments exceed the fully loaded threshold limit, resulting in an increase in amounts deducted from CET1 capital rather than being risk-weighted.

Table 1.52: Risk-weighted assets movement by key driver

	Credit risk IRB £m	Credit risk STA £m	Credit risk <sup>1</sup> £m	Counterparty Credit risk <sup>2</sup> £m	Market risk £m	Operational risk £m	Total £m
<b>Fully loaded risk-weighted assets as at 31 December 2015</b>							222,747 (10,690 )



Less total threshold risk-weighted assets<sup>3</sup>

<b>Risk-weighted assets at 31 December 2015</b>	151,563	20,443	172,006	10,153	3,775	26,123	212,057
Asset size	(4,453 )	(440 )	(4,893 )	(1,542 )	(139 )	–	(6,574 )
Acquisitions and disposals	(3,406 )	(435 )	(3,841 )	(183 )	–	–	(4,024 )
Model updates	4,363	–	4,363	99	(951 )	–	3,511
Methodology and policy	(1,215 )	(1,184 )	(2,399 )	–	–	–	(2,399 )
Asset quality	(2,989 )	(75 )	(3,064 )	729	(200 )	–	(2,535 )
Movements in risk levels (Market risk only)	–	–	–	–	662	–	662
Foreign exchange	3,802	647	4,449	367	–	–	4,816
Other	–	–	–	–	–	(831 )	(831 )
<b>Risk-weighted assets as at 31 December 2016</b>	<b>147,665</b>	<b>18,956</b>	<b>166,621</b>	<b>9,623</b>	<b>3,147</b>	<b>25,292</b>	<b>204,683</b>
Threshold risk-weighted assets <sup>3</sup>							10,763
<b>Total risk-weighted assets as at 31 December 2016</b>							<b>215,446</b>

<sup>1</sup> Credit risk includes securitisation risk-weighted assets.

<sup>2</sup> Counterparty credit risk includes movements in contributions to the default fund of central counterparties and movements in credit valuation adjustment risk.

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 reduction 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 £5.4 billion were driven by the following key movements:

– Asset size movements. Credit risk-weighted assets decreased by £4.9 billion, primarily due to active portfolio management, partially offset by continued growth in targeted customer segments.

– Disposals of the Group's interest in strategic equity investments and other targeted disposals reduced credit risk-weighted assets by £3.8 billion.

– Model update increases of £4.4 billion were mainly related to the Mainstream and buy-to-let UK mortgage portfolios.

– Methodology and policy reductions of £2.4 billion are principally due to securitisation activity.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Asset quality movements capture movements due to changes in borrower risk, including changes in the economic environment. Net reductions in credit risk-weighted assets of £3.1 billion primarily relate to model calibrations and a net change in credit quality, reflecting improvements in the economic climate, partly offset by increases in the valuation of centrally held strategic equity investments.

Foreign exchange movements reflect the depreciation of Sterling which has contributed to a £4.4 billion increase in credit risk-weighted assets.

Counterparty credit risk assets decreased by £0.5 billion mainly driven by increased capital relief from CVA related hedges partially offset by increased trading activity, foreign exchange and yield curve movements.

Market risk-weighted assets reduced by £0.6 billion due to a reduction in the Value-at-Risk multiplier, improvements to the VaR model and active portfolio management.

Operational risk-weighted assets reduced by £0.8 billion due to the annual update of the income based TSA 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 that the Group participates in the UK-wide concurrent stress test run by the Bank of England.

During 2016, the Group was subject to the European Banking Authority's Europe-wide stress test with the Group's results significantly above its minimum capital requirements. The concurrent UK stress test run by the Bank of England was also undertaken in 2016. As announced in November, the Group comfortably exceeded the capital thresholds set by the PRA and was not required to take any action as a result of this test.

## LEVERAGE RATIO

Table 1.53: Leverage ratio

	Fully loaded	
	At 31 Dec 2016 £m	At 31 Dec 2015 £m
<b>Total tier 1 capital for leverage ratio</b>		
Common equity tier 1 capital	28,899	28,505
Additional tier 1 capital	5,320	5,355
<b>Total tier 1 capital</b>	<b>34,219</b>	33,860
<b>Exposure measure</b>		
<b>Statutory balance sheet assets</b>		
Derivative financial instruments	36,138	29,467
Securities financing transactions (SFTs)	42,285	34,136
Loans and advances and other assets	739,370	743,085
<b>Total assets</b>	<b>817,793</b>	806,688
<b>Deconsolidation adjustments<sup>1</sup></b>		
Derivative financial instruments	(2,403 )	(1,510 )
Securities financing transactions (SFTs)	112	(441 )
Loans and advances and other assets	(142,990)	(133,975 )
<b>Total deconsolidation adjustments</b>	<b>(145,281)</b>	(135,926 )
<b>Derivatives adjustments</b>		
Adjustments for regulatory netting	(20,490 )	(16,419 )
Adjustments for cash collateral	(8,432 )	(6,464 )
Net written credit protection	699	682
Regulatory potential future exposure	13,188	12,966
<b>Total derivatives adjustments</b>	<b>(15,035 )</b>	(9,235 )
<b>SFT adjustments</b>	<b>39</b>	3,361
<b>Off-balance sheet items</b>	<b>58,685</b>	56,424
<b>Regulatory deductions and other adjustments</b>	<b>(9,128 )</b>	(9,112 )
<b>Total exposure</b>	<b>707,073</b>	712,200
<b>Leverage ratio<sup>2</sup></b>	<b>4.8%</b>	4.8%
<b>Average leverage ratio<sup>3</sup></b>	<b>4.9%</b>	
<b>Average leverage ratio exposure measure<sup>4</sup></b>	<b>718,914</b>	

<sup>1</sup> Deconsolidation adjustments predominantly reflect the deconsolidation of assets related to Group subsidiaries that fall outside the scope of the Group's regulatory capital consolidation (primarily the Group's Insurance entities).

<sup>2</sup> The countercyclical leverage ratio buffer is currently nil.

The average leverage ratio is based on the average of the month end tier 1 capital and exposure measures over the 3 quarter (30 September 2016 to 31 December 2016). The average of 4.9 per cent compares to 4.8 per cent at the start and end of the quarter.

<sup>4</sup> The average leverage ratio exposure measure is based on the average of the month end exposure measures over the 4 quarter (30 September 2016 to 31 December 2016).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**KEY MOVEMENTS**

The Group's fully loaded leverage ratio was increased by 9 basis points reflecting the impact of both the increase in tier 1 capital and the £5.1 billion reduction in the exposure measure, the latter largely reflecting the reduction in liquid asset holdings.

The derivatives exposure measure, representing derivative financial instruments per the balance sheet net of deconsolidation and derivatives adjustments, reduced marginally with market movements and trading activity broadly offset through netting and cash collateral inflows.

The increase in SFT assets over the period, reflecting increased customer volumes, was offset by the reduction in SFT adjustments reflecting both the recognition of additional eligible netting adjustments and a reduction in the counterparty credit risk add-on.

Off-balance sheet items increased by £2.3 billion, primarily reflecting a change in the profile and subsequent classification of commercial off-balance sheet items and a net increase in securitisation financing facilities, partially offset by a planned drawdown on certain liquidity facilities supporting the Group's conduit programme to provide funding alongside the proceeds of the ABCP issuance.

The average leverage ratio of 4.9 per cent over the quarter reflected a strengthening tier 1 capital position prior to the accrual for the announced full year special dividend and the reduction in balance sheet assets during the quarter, largely reflecting the reduction in liquid asset holdings.

**MODIFIED UK LEVERAGE RATIO**

The Group's leverage ratio on a modified basis, excluding qualifying central bank claims from the leverage exposure measure, is 5.1 per cent. This follows the rule modification applied to the UK Leverage Ratio Framework by the PRA in August 2016 as a result of recommendations made by the Financial Policy Committee.

The Financial Policy Committee has indicated that it intends to recalibrate the UK framework in 2017 in order to adjust for the impact of the rule modification, thereby ensuring that levels of capital currently required to meet

leverage ratio minimums are maintained. The modified UK leverage ratio should therefore be considered in the context of the proposed recalibration.

## **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 2016 Basel G-SIBs annual exercise will be disclosed from April 2017, 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.

## **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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### MITIGATION

The Group has taken a number of steps and have 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;

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;

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.

### STATE AID COMMITMENTS

In 2015 the Group satisfied all material structural and behavioural commitments following the successful carve-out and disposal of TSB with respect to the State Aid commitments agreed with the European Commission under the State Aid regime in 2009. The Group is therefore no longer subject to restrictive behavioural commitments including the constraint on acquisitions, but continue to be bound by two remaining limited ancillary commitments which means that the Group remains subject to supervision by the European Commission with respect to these commitments until they cease to have effect on or before June 2017.

## **INSURANCE RISK**

### **DEFINITION**

Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

### **EXPOSURES**

The major sources of insurance risk within the Group are the Insurance business and the Group's defined benefit pension schemes.

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, and exposures can arise, for example, in extreme weather conditions, such as flooding, when property damage claims are higher than expected.

The prime insurance risk of the Group's defined benefit pension schemes is longevity.



## MEASUREMENT

Insurance 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 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 33 to the financial statements. For measuring the longevity risk in the Group's defined benefit pension schemes both 1-in-20 year stresses (risk appetite) and 1-in-200 year stresses (regulatory capital) are utilised. For further information on defined benefit schemes please refer to note 36 to the financial statements.

## MITIGATION

Insurance 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. A team of longevity and bulk pricing experts has been built to support the new bulk annuity proposition.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

The most significant insurance risk in the defined benefit pension schemes is longevity risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

### MONITORING

Insurance risks in the Insurance business are monitored by Insurance senior executive Committees and ultimately the Insurance Board. Governance of the Group's defined benefit pension schemes includes two specialist pension committees. 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 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 risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken.

Progress against risk appetite metrics in respect of longevity risk in the Group's defined benefit pension schemes is regularly reported and reviewed by the relevant committees.

### PEOPLE RISK

#### DEFINITION

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver the Group's strategy for customers, shareholders and regulators.

## 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 customers' needs and deliver our 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 reviews, 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**FINANCIAL REPORTING RISK**

**DEFINITION**

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over business or finance processes impacting financial, prudential regulatory, and tax reporting, failure to manage the associated risks of changes in taxation rates, law, corporate ownership or structure and the failure to disclose timely and appropriate information in accordance with regulatory requirements.

**EXPOSURES**

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate systems, processes and controls to support statutory, prudential regulatory and tax reporting, to prevent and detect financial reporting fraud, to manage the Group's tax position and to support regulatory disclosures.

**MEASUREMENT**

Financial reporting risk is measured by the adequacy of, and compliance with, a number of key controls. Identification of potential financial reporting risk also forms a part of the Group's Operational Risk management framework.

**MITIGATION**

The Group maintains a system of internal controls, which is designed to:

— ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;

—

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; and

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 British Bankers' Association Code for Financial Reporting Disclosure.

## **MONITORING**

Financial reporting risk 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 167 to 170.

## **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 within the UK and overseas 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.

Model Risk appetite considers the performance of the Group's most material models.

## **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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 Codes of Personal Responsibility and Business 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 Codes in all aspects of their roles.

Driving adherence to the Group's RMF goes 'hand in glove' with its approach to risk culture which is embedded in the Group's 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 2016 the further 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.

As part of the RMF, the performance of models is regularly monitored to ensure they remain fit-for-purpose.

For further information on Corporate Governance see pages 152 to 176.

For further information on Model Risk see page 173.





## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## INVESTMENT PORTFOLIO, MATURITIES, DEPOSITS, SHORT-TERM BORROWINGS

**Trading securities and other financial assets at fair value through profit or loss; available-for-sale financial assets; held-to-maturity investments; and debt securities classified as loans and receivables**

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

	2016 Book value £m	2016 Valuation £m	2015 Book value £m	2015 Valuation £m	2014 Book value £m	2014 Valuation £m
<b>Trading securities and other financial assets at fair value through profit or loss</b>						
US treasury and US government agencies	1,607	1,607	663	663	658	658
Other government securities	25,125	25,125	21,454	21,454	24,815	24,815
Other public sector securities	1,325	1,325	2,039	2,039	2,170	2,170
Bank and building society certificates of deposit	244	244	135	135	554	554
Mortgage-backed securities	707	707	1,358	1,358	1,034	1,034
Other asset-backed securities	1,538	1,538	847	847	850	850
Corporate and other debt securities	19,832	19,832	20,316	20,316	22,090	22,090
Treasury bills and other bills	20	20	74	74	1,459	1,459
Equity shares	67,697	67,697	60,476	60,476	61,576	61,576
	<b>118,095</b>	<b>118,095</b>	<b>107,362</b>	<b>107,362</b>	<b>115,206</b>	<b>115,206</b>
<b>Available-for-sale financial assets</b>						
US treasury and US government agencies	7,564	7,564	6,349	6,349	7,226	7,226
Other government securities	41,150	41,150	18,980	18,980	40,176	40,176
Bank and building society certificates of deposit	142	142	186	186	298	298
Mortgage-backed securities	108	108	197	197	674	674
Other asset-backed securities	317	317	319	319	685	685
Corporate and other debt securities	6,030	6,030	5,808	5,808	5,529	5,529
Treasury bills and other bills	–	–	–	–	863	863
Equity shares	1,213	1,213	1,193	1,193	1,042	1,042
	<b>56,524</b>	<b>56,524</b>	<b>33,032</b>	<b>33,032</b>	<b>56,493</b>	<b>56,493</b>
<b>Held-to-maturity investments</b>						
UK government	–	–	19,808	19,851	–	–
<b>Debt securities classified as loans and receivables</b>						
Mortgage-backed securities	2,089	2,065	2,528	2,493	190	155
Other asset-backed securities	1,290	1,227	1,234	1,173	985	900
Corporate and other debt securities	94	11	526	441	164	45

Edgar Filing: Lloyds Banking Group plc - Form 20-F

	<b>3,473</b>	<b>3,303</b>	4,288	4,107	1,339	1,100
Allowance for impairment losses	<b>(76 )</b>	<b>–</b>	(97 )	–	(126 )	–
	<b>3,397</b>	<b>3,303</b>	4,191	4,107	1,213	1,100

113

## 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 2016 by the book value of securities held at that date.

	Maturing within one year		Maturing after one but within five years		Maturing after five but within ten years		Maturing after ten years	
	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %
<b>Trading securities and other financial assets at fair value through profit or loss</b>								
US treasury and US government agencies	–	–	407	1.22	93	2.02	1,107	2.24
Other government securities	390	1.68	3,484	3.26	2,602	1.89	18,649	2.60
Other public sector securities	–	–	238	2.61	86	3.37	1,001	2.95
Bank and building society certificates of deposit	244	0.93	–	–	–	–	–	–
Mortgage-backed securities	–	–	37	1.14	105	4.61	565	2.83
Other asset-backed securities	–	–	121	3.65	583	2.44	834	3.73
Corporate and other debt securities	12,456	3.48	3,404	5.59	2,841	4.04	1,131	4.15
Treasury bills and other bills	20	0.50	–	–	–	–	–	–
	13,110		7,691		6,310		23,287	
<b>Available-for-sale financial assets</b>								
US treasury and US government agencies	–	–	4,651	2.78	2,652	5.76	262	3.85
Other government securities	539	0.99	9,045	3.79	15,531	3.05	16,034	3.69
Bank and building society certificates of deposit	142	0.07	–	–	–	–	–	–
Mortgage-backed securities	9	2.44	4	1.00	–	–	95	0.76
Other asset-backed securities	–	–	–	–	41	1.02	276	0.97
Corporate and other debt securities	628	1.28	4,267	1.50	1,134	2.04	1	0.00
	1,318		17,967		19,358		16,668	
<b>Debt securities classified as loans and receivables</b>								
Mortgage-backed securities	–	–	–	–	30	1.8	2,059	1.0
Other asset-backed securities	248	0.2	32	0.3	779	1.1	231	1.8
Corporate and other debt securities	2	0.0	2	0.0	–	–	90	0.0
	250		34		809		2,380	

The Group's investment holdings at 31 December 2016 include £63,253 million due from the UK government and its agencies and £9,172 million due from the US government and its agencies.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AT 31 DECEMBER 2016**

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis at 31 December 2016. 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.

	<b>Maturing in one year or less £m</b>	<b>Maturing after one but within five years £m</b>	<b>Maturing after five years £m</b>	<b>Total £m</b>
Loans and advances to banks	21,812	4,973	117	26,902
Loans and advances to customers:				
Mortgages	11,614	47,535	247,533	306,682
Other personal lending	5,418	4,621	10,722	20,761
Property companies	5,266	10,404	16,522	32,192
Financial, business and other services	26,234	13,311	9,652	49,197
Transport, distribution and hotels	6,097	4,649	2,574	13,320
Manufacturing	4,598	2,133	554	7,285
Other	9,807	13,311	7,815	30,933
<b>Total loans</b>	<b>90,846</b>	<b>100,937</b>	<b>295,489</b>	<b>487,272</b>
Of which:				
Fixed interest rate	23,434	29,776	102,631	155,841
Variable interest rate	67,412	71,161	192,858	331,431
	<b>90,846</b>	<b>100,937</b>	<b>295,489</b>	<b>487,272</b>

**DEPOSITS**

The following tables show the details of the Group's average customer deposits in each of the past three years.

Edgar Filing: Lloyds Banking Group plc - Form 20-F

	<b>2016</b>	<b>2016</b>	2015	2015	2014	2014
	<b>Average</b>	<b>Average</b>	Average	Average	Average	Average
	<b>balance</b>	<b>rate</b>	balance	rate	balance	rate
	<b>£m</b>	<b>%</b>	£m	%	£m	%
Non-interest bearing demand deposits	<b>54,379</b>	–	45,294	–	42,049	–
Interest-bearing demand deposits	<b>90,272</b>	<b>0.48</b>	83,756	0.47	82,545	0.80
Savings deposits	<b>164,155</b>	<b>0.57</b>	174,239	1.00	201,046	1.18
Time deposits	<b>111,751</b>	<b>1.05</b>	122,142	0.99	133,060	1.32
<b>Total average deposits</b>	<b>420,557</b>	<b>0.60</b>	425,431	0.79	458,700	1.04

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 2016 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.

	<b>3</b>	<b>Over 3</b>	<b>Over 6</b>	<b>Over</b>	<b>Total</b>
	<b>months</b>	<b>months</b>	<b>months</b>	<b>12</b>	
	<b>or less</b>	<b>but</b>	<b>but</b>	<b>12</b>	
		<b>within</b>	<b>within</b>	<b>months</b>	
		<b>6</b>	<b>12</b>		
	<b>£m</b>	<b>months</b>	<b>months</b>	<b>£m</b>	<b>£m</b>
Certificates of deposit	<b>2,668</b>	<b>3,692</b>	<b>1,642</b>	<b>70</b>	<b>8,072</b>
Time deposits	<b>26,051</b>	<b>5,877</b>	<b>6,778</b>	<b>4,692</b>	<b>43,398</b>
<b>Total</b>	<b>28,719</b>	<b>9,569</b>	<b>8,420</b>	<b>4,762</b>	<b>51,470</b>

## 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.

	<b>2016</b>	2015	2014
	<b>£m</b>	£m	£m
<b>Liabilities in respect of securities sold under repurchase agreements</b>			
Balance at the year end	<b>9,741</b>	7,061	1,075
Average balance for the year	<b>8,342</b>	5,960	2,104
Maximum balance during the year	<b>12,734</b>	9,467	9,971
Average interest rate during the year	<b>0.5%</b>	0.6%	1.1%
Interest rate at the year end	<b>0.6%</b>	0.6%	1.2%
<b>Certificates of deposit issued</b>			
Balance at the year end	<b>8,077</b>	11,101	7,033
Average balance for the year	<b>11,200</b>	11,708	9,912
Maximum balance during the year	<b>13,712</b>	13,925	11,376
Average interest rate during the year	<b>0.6%</b>	0.4%	0.4%
Interest rate at the year end	<b>0.7%</b>	0.2%	0.3%
<b>Commercial paper</b>			
Balance at the year end	<b>3,281</b>	6,663	7,373
Average balance for the year	<b>4,666</b>	5,286	8,432
Maximum balance during the year	<b>7,646</b>	12,700	14,768
Average interest rate during the year	<b>0.9%</b>	0.6%	0.3%
Interest rate at the year end	<b>0.0%</b>	0.0%	0.1%
<b>Securitisation notes</b>			
Balance at the year end	<b>7,253</b>	7,763	11,908
Average balance for the year	<b>7,131</b>	10,362	13,836
Maximum balance during the year	<b>7,436</b>	12,155	15,787
Average interest rate during the year	<b>2.5%</b>	2.4%	2.1%
Interest rate at the year end	<b>2.2%</b>	2.7%	2.0%
<b>Covered bonds</b>			
Balance at the year end	<b>30,521</b>	27,200	27,191
Average balance for the year	<b>30,625</b>	26,503	29,754

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Maximum balance during the year	<b>32,444</b>	27,200	31,684
Average interest rate during the year	<b>3.5%</b>	4.2%	4.5%
Interest rate at the year end	<b>3.0%</b>	3.7%	4.3%

116



## 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 2016, a total of 9 Board meetings were held, 9 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; 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. Major shareholders are also offered the opportunity to meet new Non-Executive Directors.

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

## **NON-EXECUTIVE DIRECTORS**

### **Lord Blackwell**

*Chairman*

Age: 64

Chairman of the Nomination and Governance Committee, member of the Board Risk Committee, the Remuneration Committee and the Responsible Business Committee.

Appointed: June 2012 (Board), April 2014 (Chairman)

**Skills and experience:** Lord Blackwell has deep financial services knowledge including in insurance and banking, as well as regulatory and public policy experience gained from senior positions in a wide range of industries. His breadth of experience, credibility with key stakeholders and strong leadership qualities make him an effective Chairman. Lord Blackwell was previously the Chairman of Scottish Widows Group, and Interserve plc, Director of Group Development at NatWest Group, a Senior Independent Director of Standard Life and also chaired their UK Life and Pensions Board. His past Non-Executive Directorships have included 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.

**Anita Frew**

*Deputy Chairman and Independent Director*

Age: 59

Chairman of the Remuneration Committee, member of the Audit Committee, the Board Risk Committee, the Nomination and Governance Committee and the Responsible Business Committee.

Appointed: December 2010 (Board), May 2014 (Deputy Chairman)

**Skills and experience:** Anita has significant board, financial and general management experience across a range of sectors, including banking, asset and investment management, manufacturing and utilities. She 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. Her extensive board level, asset and investment management experience makes her a strong Deputy Chairman and Chairman of the Remuneration Committee. She has a BA (Hons) in International Business from the University of Strathclyde, a MRes in Humanities and Philosophy from the University of London and an Honorary DSc for contribution to industry and finance from the University of Cranfield.

**External appointments:** Chairman of Croda International Plc and a Non-Executive Director of BHP Billiton.

**Alan Dickinson**

*Independent Director*

Age: 66

Chairman of the Board Risk Committee, member of the Audit Committee, the Remuneration Committee and the Nomination and Governance Committee.

Appointed: September 2014

**Skills and experience:** Alan is a highly regarded retail and commercial banker having spent 37 years with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK. More recently, he was a Non-Executive Director of Willis Limited and Chairman of its Risk Committee. He was formerly

117

## MANAGEMENT AND EMPLOYEES

Chairman of Brown, Shipley & Co. Limited and a Non-Executive Director of Nationwide Building Society where he was Chairman of its Risk Committee. Alan's strategic focus and core banking experience complements the balance of skills on our Board and makes him ideal for the role of Chairman of the Board 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 Bachelor of Science from the University of Birmingham.

**External appointments:** Chairman of Urban & Civic plc and a Governor of Motability.

### **Simon Henry**

*Independent Director*

Age: 55

Member of the Audit Committee and the Board Risk Committee.

Appointed: June 2014

**Skills and experience:** Simon has deep international experience in board level strategy and execution. His extensive knowledge of financial markets, treasury and risk management and his qualification as an Audit Committee Financial Expert is of particular value in our Board Risk and Audit Committees. Simon has a BA in Mathematics, an MA from the University of Cambridge and is a fellow of the Chartered Institute of Management Accountants.

**External appointments:** Chair of the European Round Table CFO Taskforce, Member of the Main Committee of the 100 Group of UK FTSE CFOs, the Advisory Panel of CIMA and of the Advisory Board of the Centre for European Reform. Non-Executive Director of Rio Tinto plc and Rio Tinto Limited (from 1 July 2017). Chief Financial Officer and Executive Director of Royal Dutch Shell plc until 9 March 2017 and will remain available to his successor and the Board of Royal Dutch Shell plc to assist with transition until 30 June 2017.

### **Nick Luff**

*Independent Director*

Age: 49

Chairman of the Audit Committee, member of the Board Risk Committee and the Nomination and Governance Committee.

Appointed: March 2013

**Skills and experience:** Nick has significant financial experience in the UK listed environment having served in a number of senior finance positions within a range of sectors. His background and experience enables him to fulfil the role of Audit Committee Chair and, for SEC purposes, the role of Audit Committee Financial Expert. Nick was previously the Group Finance Director of Centrica plc, Finance Director of The Peninsular & Oriental Steam Navigation Company and Chief Financial Officer of P&O Princess Cruises plc. He previously served as a Non-Executive Director and was the Audit Committee Chair of QinetiQ Group plc. He is a Mathematics graduate from the University of Oxford and a Chartered Accountant.

**External appointments:** Executive Director and Chief Financial Officer of RELX Group.

**Deborah McWhinney**

*Independent Director*

Age: 61

Member of the Audit Committee and the Board Risk Committee.

Appointed: December 2015

**Skills and experience:** Deborah has an extensive executive background in managing technology, operations and new digital innovations across banking, payments and institutional investment. She broadens the Board's diversity from a

global market perspective. Deborah is a former Chief Executive Officer, Global Enterprise Payments and President, Personal Banking and Wealth Management at Citibank. She 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: 56

Member of the Audit Committee and the Board Risk Committee.

Appointed: June 2014

**Skills and experience:** Nick has significant financial services experience, particularly in insurance where he has served as Chief Executive of Lloyd's of London and Prudential UK and Europe as well as 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. He has the knowledge and experience to provide valuable insight and contribute effectively as a Non-Executive Director and Member of the Audit Committee and Risk Committee as well as the governance experience and leadership qualities to chair Scottish Widows Group. Nick has a First Class Degree in Philosophy, Politics and Economics from Balliol College, University of Oxford.

**External appointments:** Member of the BBC Trust (until 31 March 2017), Chairman of the Britten-Pears Foundation, the Royal Northern College of Music and the Financial Conduct Authority's Financial Advice Working Group.

### **Stuart Sinclair**

*Independent Director*

Age: 63

Member of the Board Risk Committee and the Remuneration Committee.

Appointed: January 2016

**Skills and experience:** Stuart has extensive experience in retail banking, insurance and consumer finance. He is a former Non-Executive Director of TSB Banking Group plc, TSB Bank plc, LV Group and Virgin Direct. In his executive career, he was President and Chief Operating Officer of Aspen

118



MANAGEMENT AND EMPLOYEES

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:** Non-Executive Director and Chair of the Risk Committee at Provident Financial plc, Senior Independent Director and Chair of Risk at QBE Insurance (Europe) Limited and Senior Independent Director and Chair of Risk at Swinton Group Limited.

**Anthony Watson CBE**

*Senior Independent Director*

Age: 71

Member of the Audit Committee, the Board Risk Committee, the Remuneration Committee and the Nomination and Governance Committee.

Appointed: April 2009 (Board), May 2012 (Senior Independent Director)

**Skills and experience:** Tony is our Senior Independent Director and with over 40 years of experience in the investment management industry and related sectors, he is well placed to carry out this role. His former positions include Chief Executive of Hermes Pensions Management and Chairman of the Asian Infrastructure Fund, MEPC, the Marks & Spencer Pension Trustees and of the Strategic Investment Board (Northern Ireland). He is also a former Member of the Financial Reporting Council, a Senior Independent Director of Hammerson and a Non-Executive Director of the Shareholder Executive and Vodafone Group. He has a BSc (Hons) in Economics from Queen's University Belfast, a Diploma in Security Analysis from the New York Institute of Finance and is a Barrister at Law, England and Wales.

**External appointments:** Senior Independent Director of Witan Investment Trust, Chairman of the Lincoln's Inn Investment Committee and a member of the Norges Bank Investment Management Corporate Governance Advisory Board.

**Sara Weller CBE**

*Independent Director*

Age: 55

Chairman of the Responsible Business Committee, member of the Board Risk Committee and the Remuneration Committee.

Appointed: February 2012

**Skills and experience:** With a background in retail and associated sectors, including financial services, Sara brings a broad perspective to the Board. She is a passionate advocate of customers, the community, financial inclusion and the development of digital skills which directly support Lloyds Banking Group's strategy and her role as Chairman of the Responsible Business Committee. Sara has considerable experience of boards at both executive and non-executive level. Her previous appointments include Managing Director of Argos, various senior positions at J Sainsbury including Deputy Managing Director, 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, a Governing Council Member of Cambridge University, Chairman of the Planning Inspectorate and Board member at the Higher Education Funding Council.

**EXECUTIVE DIRECTORS**

**António Horta-Osório**

*Executive Director and Group Chief Executive*

Age: 53

Appointed: January 2011 (Board), March 2011 (Group Chief Executive)

**Skills and experience:** António brings extensive experience in, and understanding of, both retail and commercial banking. This has been built over a period of more than 30 years, working both internationally as well as in the UK. António's drive, enthusiasm and commitment to customers, along with his proven ability to build and lead strong management teams, brings significant value to all stakeholders of Lloyds Banking Group. Previously he worked for Goldman Sachs, Citibank and held various senior management positions at Grupo Santander before becoming its Executive Vice President. 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 and Governor of the London Business School. 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: 54

Appointed: May 2012 (Board)

**Skills and experience:** George has extensive operational and financial expertise including strategic and financial planning and control. He has 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.

## COMPENSATION

### **Juan Colombás**

*Executive Director and Chief Risk Officer*

Age: 54

Appointed: January 2011 (Chief Risk Officer), November 2013 (Board)

**Skills and experience:** Juan has significant banking and risk management experience, having spent 31 years working in these fields both internationally and in the UK. Juan is responsible for developing the Group's risk framework, recommending its risk appetite and ensuring that all risks generated by the business are 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 position, he held a number of senior risk, control and business management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group. He has served as the Group's Chief Risk Officer and as a member of the Group Executive Committee since January 2011. 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:** Vice Chairman of the International Financial Risk Institute.

## EMPLOYEES

As at 31 December 2016, the Group employed 70,433 people (on a full-time equivalent basis), compared with 75,306 at 31 December 2015 and 84,490 at 31 December 2014. At 31 December 2016, 69,649 employees were located in the UK, 394 in continental Europe, 328 in the Americas, and 62 in the rest of the world. At the same date, 29,639 people were employed in Retail, 5,816 in Commercial Banking, 3,399 in Consumer Finance, 1,874 in Insurance, 19,213 in Group Operations and 10,492 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](http://www.lloydsbankinggroup.com/Responsible-Business).

## DIRECTORS' REMUNERATION

The Committee's focus goes beyond executive pay to ensure that the interests of all colleagues and shareholders are considered fairly and consistently.

### KEY MESSAGES

Remuneration review concluded in 2016, resulting in revised Reward Principles and variable remuneration design aligned to the Group's strategic priorities.

Strong financial performance overall and further progress against strategic priorities, supporting bonus outcome of £392.9 million. This included a 19 per cent downward collective adjustment and equates to 4.8 per cent of pre-bonus underlying profit.

Executive Director 2016 bonus awards approximately 77 per cent of maximum.

Executive Director single figure remuneration outcomes approximately 35 per cent lower than 2015, with 2014 Long-Term Incentive Plan awards vesting at 55 per cent of maximum.

Consistent 2 per cent base salary budget applied to all colleagues, including Executive Directors.

To build a long-term ownership culture, all colleagues will, for the first time, receive an award of shares under the new Group Ownership Share Plan.

On behalf of the Board and as Chair of the Group's Remuneration Committee, I have pleasure in presenting the Directors' remuneration report for the year ended 31 December 2016. I am very grateful for the continued support and engagement we have had with shareholders and their representative bodies, especially during consultations on the outcomes of the remuneration review which I outlined in last year's statement and which was a key priority for 2016.

### OUTCOMES OF THE REMUNERATION REVIEW

The Committee conducted a full review of the Group's remuneration arrangements in 2016. The main focus of this review was to ensure the remuneration arrangements support our purpose of helping Britain prosper and align to the Group's aim of becoming the best bank for customers whilst delivering superior and sustainable returns for shareholders. With this in mind, the Committee simplified and updated the Reward Principles that apply across the Group to ensure they support the strategic priorities, as set out below:

Further detail is set out in the 'Summary of the remuneration review'.

There are no significant changes to the remuneration policy for Executive Directors that is being put to a binding vote at the 2017 AGM, and the maximum opportunity for both the short-term and long-term elements of variable remuneration will remain the same.

120

## COMPENSATION

### FAIR REWARD FOR COLLEAGUES

The Committee's focus goes beyond executive pay. I have engaged with the Group's recognised unions, and I am keen to ensure that the interests of all colleagues are considered in the Committee's deliberations. We are mindful of the relationship between pay for executives and more junior colleagues, and to that end have sought to ensure consistency of pay outcomes with a salary budget of 2 per cent applied across the whole Group. In order to ensure that the Committee's approach to remuneration aligns to Group strategy, I have engaged the Responsible Business Committee in discussions on pay. This dialogue will continue during 2017.

In 2016, the Group has completed the moves to ensure that all customer-facing colleagues in Retail are now incentivised by reference to Balanced Scorecard metrics, rather than individual or branch level sales or product targets. This change ensures that colleagues are rewarded for action and behaviour that puts customers first. All variable remuneration decisions take into consideration the Group's Value, Codes of Responsibility, and the Conduct Pillars (Integrity, Compliance and Competence).

### SHARING IN THE GROUP'S PERFORMANCE

As part of considering the structure of remuneration, the Committee concluded that it was important all colleagues should understand that they share in the overall performance of the Group alongside other stakeholders. The short-term variable remuneration element that supports this will be known as the 'Group Performance Share plan'.

The plan outcome will be determined 'top-down' as a percentage of the Group's underlying profit, modified based on the Group's Balanced Scorecard performance and any collective adjustment for risk and conduct matters. The clear and transparent link between risk-adjusted profit and the Group Performance Share plan outcome ensures direct alignment between the interests of colleagues (including Executive Directors) and shareholders.

### BUILDING A LONG-TERM OWNERSHIP CULTURE

The Group promotes the broadest possible share ownership by colleagues to build a culture of acting as stewards of the long-term interests of the Group.

Over 80 per cent of colleagues hold an interest in the Group through participation in one of our existing share plans. To achieve 100 per cent share ownership, for the first time in 2017, all colleagues in the Group will receive an award of shares valued at £200, which they will be required to hold for at least three years. We will look to repeat awards in future years, dependent on delivering against the Group's strategic aims.

Executive-level share ownership is high, with all Executive Director shareholdings well above their minimum requirement under the shareholding policy. The Group Chief Executive's current shareholding significantly exceeds the level required, as detailed in the annual report on remuneration.

To align with the culture of broader share ownership, the long-term element of variable remuneration will be known as the 'Group Ownership Share plan'. This plan incentivises and rewards Executive Directors and senior colleagues against Group financial and strategic objectives designed to deliver superior and sustainable long-term returns for shareholders. Executives will build a direct ownership interest in the Group if those strategic objectives are met over the three-year performance period. The Committee decided that the performance measures for the 2017 awards should align to the revised Reward Principles, and with that, the Group's strategic priorities.

#### REMUNERATION OUTCOMES FOR 2016

The Group has delivered strong financial performance in 2016 following further strategic progress. Underlying profit was £7.9 billion and statutory profit has more than doubled to £4.2 billion. The Group's balance sheet remains strong and capital generation of approximately 190 basis points has enabled the Group to increase the ordinary dividend, pay a special dividend and fully cover the expected capital impact of the MBNA acquisition.

The gross bonus that results from underlying profit modifiers and Balanced Scorecard performance is £484.1 million. In reaching the final decision on the 2016 bonus outcome, the Committee considered the conduct-related provisions, including an additional provision for PPI in 2016. This led to a downward adjustment of 19 per cent resulting in a final bonus outcome for 2016 of £392.9 million. This is an increase of 11 per cent compared to 2015.

The Group's bonus outcome is amongst the lowest of large UK banks and at 4.8 per cent of pre-bonus underlying profit, significantly lower than the Group's funding limit of 10 per cent of pre bonus underlying profit.

A formulaic approach has been used to set the Executive Directors' bonus awards, consistent with other colleagues across the Group. The Committee determined that bonus awards of between 77 per cent and 78 per cent of maximum should be made to Executive Directors. Each of these awards, as well as the proposed Group Ownership Share awards detailed in the report, reflect the Group's strong underlying performance against both financial and Balanced Scorecard metrics.



The long-term incentive plan (LTIP) awards made in 2014 are proposed to vest at 55 per cent, reflecting performance in the period to 31 December 2016.

Overall, the total remuneration for the Executive Directors is down by around 35 per cent compared to 2015. Further details on the reward outcomes for Executive Directors are outlined in the annual report on remuneration.

The Group's approach to deferral of total variable remuneration ensures that both the short-term and long-term elements are subject to deferral in a way that results in a slower release of variable remuneration than the minimum regulatory requirements. In line with the new PRA remuneration requirements for PRA Senior Managers, the Group Ownership Share element is deferred over seven years with pro rata vesting between the third and seventh year.

Across all colleagues, less than 3.5 per cent of annual bonus plan awards are above £25,000 and relate to high performing colleagues at senior levels. The first £2,000 of any bonus award continues to be paid in cash in March 2017, with the balance deferred in shares which are released periodically over subsequent months and years.

#### 2017 EXECUTIVE DIRECTOR SALARIES

It was the Committee's intent that Executive Director salary increases remain aligned with the 2 per cent budget for all colleagues. With that principle in mind, the Committee proposes to increase the base salaries of the Chief Financial Officer and the Chief Risk Officer by 2 per cent.

As disclosed in the 2015 Directors' remuneration report, for the first time since 2011, a salary increase was applied in 2016 for the Group Chief Executive to begin to adjust his base salary to the previously disclosed Reference Salary of £1.22 million, which was set relative to the market when he joined in 2011, and for the adjustment to be staged over two years. As a result the second stage of the adjustment to £1.22 million is to be implemented with effect from January 2017, with 2 per cent of the increase delivered in cash and the remainder in shares.

#### 2017 ANNUAL GENERAL MEETING

Approval for the Directors' remuneration policy will be sought at the AGM on 11 May 2017; if approved, it will take effect from that date. I hope you will support the resolutions relating to remuneration.

## COMPENSATION

## SUMMARY OF THE REMUNERATION REVIEW

## ENHANCING THE LINK BETWEEN REMUNERATION AND STRATEGY

As part of the review of the Group's variable remuneration arrangements in 2016, the existing reward principles were simplified and updated to ensure they support the Group's strategic priorities. The table below shows the link between strategic priorities, the reward principles and performance measures for the Group Ownership Share and Group Performance Share plans. Further detail can be found in the strategic report.

<b>Strategic priorities</b>	<b>Reward principle</b>	<b>Long-term measures (Group Ownership Share plan)</b>	<b>Short-term measures (Group Performance Share plan), examples include:</b>
	<b>CUSTOMER ALIGNMENT</b>		
		– Net promoter score	– Helping Britain Prosper Plan
Creating the best customer experience	– Rewards action and behaviour which puts customers first	– FCA total reportable complaints per 1,000 accounts and Financial Ombudsman Service (FOS) uphold rate	– Best Bank for Customers index
	– Builds a responsible business plan that helps Britain prosper	– Digital active customer base	– Digital active customer base
Becoming simpler and more efficient	– Supports the Culture Plan <b>SIMPLE, AFFORDABLE AND MOTIVATING</b>	– Cost:income ratio	– Cost:income ratio
	– Flexible and simple	– Economic profit	
	– Transparent and understood (by colleagues and other stakeholders)		

	<ul style="list-style-type: none"> <li>– Motivating awards which colleagues value</li> </ul>		
	SHAREHOLDER ALIGNMENT		
			– Underlying profit before tax
Delivering sustainable growth	<ul style="list-style-type: none"> <li>– Supports delivery of long-term, superior and sustainable returns</li> </ul>		
		– Absolute Total Shareholder Return	– Common equity tier 1 (CET1) ratio
	<ul style="list-style-type: none"> <li>– Promotes sound and effective risk management</li> </ul>		– PRA stress test
	<ul style="list-style-type: none"> <li>– Complies with regulations</li> </ul>		
	COMPETITIVE, PERFORMANCE-DRIVEN AND FAIR		
			– Performance excellence index
Building the best team	<ul style="list-style-type: none"> <li>– Drives successful change towards Bank of the Future</li> </ul>		
		– Employee engagement index	– Employee engagement index
	<ul style="list-style-type: none"> <li>– Encourages working together as one team</li> </ul>		– Inclusion & Diversity
	<ul style="list-style-type: none"> <li>– Delivers fair outcomes, based on performance, not personal characteristics</li> </ul>		

The Group’s remuneration arrangements support its purpose of helping Britain prosper and align to the Group’s aim of becoming the best bank for customers, whilst delivering long-term, superior and sustainable returns for shareholders.

The Group believes in offering fair reward. It fosters a performance-driven and meritocratic culture where colleagues share in the collective success of the Group and are rewarded for performance aligned to the long-term sustainable success of the business and the commitment to changing the culture of the Group.

The new variable remuneration arrangements have been designed to reinforce the simplified reward principles and maintain a separate short-term and long-term model. Remuneration remains weighted towards the long-term and the design closely aligns to the Group's strategic priorities. There have not been any changes to the maximum potential under either plan.

The graphic below summarises the elements of the Executive Directors' total remuneration package for 2017.

### **SIMPLIFYING THE APPROACH TO SHORT-TERM VARIABLE REMUNERATION: GROUP PERFORMANCE SHARE**

The Group Performance Share plan provides Executive Directors and colleagues with a reward for delivery against the Group's short-term financial and strategic priorities. The annual performance share outcome is based on a percentage of the Group's underlying profit, adjusted by a strategic multiplier based on the Group's Balanced Scorecard (BSC) metrics and risk matters. This approach replaces the more complex methodology used in recent years where the Group's total bonus outcome was driven by the aggregate divisional and functional bonus outcomes and provides a clear line of sight for Executive Directors, colleagues and shareholders.

## COMPENSATION

In order to ensure that the opportunity under the Group Performance Share plan is not increased when compared to the previous annual bonus plan, the Committee has included threshold and maximum payout levels. The maximum for 2017 is 20 per cent above the underlying profit target and a 'Top' rating against Balanced Scorecard objectives. This is consistent with prior years. The threshold is set at 20 per cent below the Group's underlying profit target.

### **LONG-TERM VARIABLE REMUNERATION: GROUP OWNERSHIP SHARE**

From 2017, the long-term incentive plan will be known as the Group Ownership Share plan to reinforce its link to the Group's strategic priorities and provide greater shareholder alignment. The Group Ownership Share plan ensures Executive Directors and senior colleagues build an ownership interest in the Group and are motivated by delivering long-term superior and sustainable returns for shareholders. Vesting is subject to future three-year performance with a clear link between measures and key strategic priorities.

### **2017 DEFERRAL OF VARIABLE REMUNERATION**

Under new PRA remuneration requirements, 60 per cent of variable remuneration awarded to PRA Senior Managers must be deferred for seven years with pro rata vesting between the third and seventh year. The Group's approach ensures that both short-term and long-term variable remuneration is subject to deferral and is more onerous than the minimum PRA requirements, as over 60 per cent of variable remuneration awarded to Executive Directors is deferred under the Group Ownership Share plan and vests over a period of seven years from the date of grant.

Due to this more onerous approach under the Group Ownership Share plan, awards for Executive Directors under the Group Performance Share plan are deferred for two years as follows:

- 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.

The graphic below illustrates how the Group's deferral approach for Executive Directors (who are PRA Senior Managers for regulatory purposes) continues to be weighted to the long term, underpinning the strategic priority and reward principle of delivering sustainable growth. Any shares released are subject to a further holding period in line with regulatory requirements and market practice. In line with shareholder expectations, no Group Ownership Share awards are unconditionally released until at least five years after grant.

## COMPENSATION

## REMUNERATION AT A GLANCE

## HOW LLOYDS BANKING GROUP PERFORMED

## KEY PERFORMANCE MEASURES

The table below illustrates outcomes against the Group's key performance measures relevant to remuneration.

The annual bonus outcome is driven by a combination of Group underlying profit and Balanced Scorecard performance. The long-term incentive plan measures Group performance over a three-year period, using a range of financial and strategic measures.

Measure	2016	2015
Underlying profit before tax	<b>£7,867m</b>	£8,112m <sup>1</sup>
Group Balanced Scorecard	<b>Strong plus</b>	Strong
Economic profit	<b>£3,377m</b>	£2,233m
Total Shareholder Return (TSR)		
Per annum for the three years ended 31 December	<b>(5%</b> )	16.6%
Cost:income ratio	<b>48.7%</b> <sup>2</sup>	49.3%
Net promoter score	<b>62.7</b>	59.3
Digital active customer base	<b>12.5m</b>	11.5m
Employee engagement index	<b>71</b>	71

<sup>1</sup>The underlying profit result used for remuneration purposes was £7,994 million (excluding TSB).

<sup>2</sup>The adjusted cost:income ratio result used for remuneration purposes was 50.5 per cent.

## ANNUAL BONUS PLAN OUTCOME

The Group has delivered strong financial performance in 2016 following further strategic progress. In reaching the decision on the 2016 bonus outcome, the Committee considered the conduct-related provisions, including an additional provision for PPI in 2016. This led to a downward adjustment of 19 per cent.

The total bonus award as a percentage of pre-bonus underlying profit before tax increased from 4.2 per cent in 2015 to 4.8 per cent in 2016. This compares favourably to shareholder return from dividend payments over the same period which increased to 26.3 per cent of underlying profit and remains significantly lower than the Group's funding limit of 10 per cent of pre bonus underlying profit.

For Executive Directors, awards of between 77 per cent and 78 per cent of maximum opportunity were determined reflecting Group and individual performance.

### **LONG-TERM INCENTIVE PLAN OUTCOME**

The Group has delivered a good financial performance over the performance period of the 2014 Long-Term Incentive Plan (LTIP) awards, continuing to transform the business for the benefit of its shareholders. Performance was measured over three financial years ended 31 December 2016. The performance conditions attached to these awards and actual performance are set out in the table below. At the end of the performance period, it has been assessed that awards will vest at 55 per cent of maximum. Executive Directors are required to retain any shares vesting for a further two years post vesting.



## COMPENSATION

### 1 Adjusted total costs.

FCA reportable complaints per 1,000 for the period up to and including H1 2016 and formally closed FCA complaints per 1,000 accounts for the period from H2 2016. Both exclude PPI complaints, any complaints received via Claims Management Companies (CMC) and any complaints relating to TSB activity. With the introduction of the FCA guidance contained in PS15/19 applicable from 1 July 2016, the complaint classification and reporting for the original metric ceased on 30 June 2016. Accordingly, the Remuneration Committee has rebased the original 2014 metrics in line with the new FCA reporting regime. The Remuneration Committee considers the rebased targets equally stretching.

## EXECUTIVE DIRECTOR REMUNERATION OUTCOMES

The charts below summarise the Executive Directors' remuneration for the years ended 31 December 2015 and 2016.

### 1 2016 bonus, awarded in March 2017.

2014 LTIP vesting and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 15 February 2017. The average share price between 1 October 2016 and 31 December 2016 (58.30 pence) has been used to calculate the value. The shares were awarded in 2014 based on a share price of 78.878 pence.

## DIRECTORS' FIXED REMUNERATION FOR 2017

### BASE SALARY

2017 base salaries will be as follows:

Group Chief Executive: £1,220,000 (1 January 2017)

Chief Financial Officer: £764,070 (1 April 2017)

Chief Risk Officer: £753,458 (1 January 2017)

#### FIXED SHARE AWARD

The levels of award set for 2017 remain unchanged and are as follows:

Group Chief Executive: £900,000

Chief Financial Officer: £504,000

Chief Risk Officer: £497,000

125

## COMPENSATION

**DIRECTORS' REMUNERATION POLICY**

Approval for this remuneration policy will be sought at the AGM on 11 May 2017 and, if approved, will take 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. Information on how the Policy will be implemented in 2017 is included in the annual report on remuneration.

The Group's policy continues to help ensure that the remuneration proposition is both cost effective and enables the Group to attract and retain executives of the highest calibre. The objective is to align individual reward with the Group's performance, the interests of its shareholders and a prudent approach to risk management. In this way, the requirements of the major stakeholders are balanced: customers, shareholders, employees, and regulators.

The policy is based on principles which are applicable to all employees within the Group and, in particular, the principle that the reward package should support the delivery of the Group's purpose of helping Britain prosper and the strategic aim of becoming the best bank for customers whilst delivering long-term superior and sustainable returns to shareholders. It fosters a performance-driven and meritocratic culture, encourages effective risk disciplines and is in line with relevant regulations and codes of best practice. There is no significant difference between the policy for Executive Directors and that for other senior employees. If a significant difference for any individual were proposed, this would be subject to approval by the Remuneration Committee (within regulatory requirements). The table below summarises how the policy applies across the Group.

		Executive Directors	Group Executive Committee	Other Material Risk Takers	Other employees
Fixed	Base salary				
	Fixed share award <sup>1</sup>				
	Pension and benefits				
Variable	Short-term incentive				
	Long-term incentive			1	1

<sup>1</sup> Eligibility based on seniority, grade and role.

## CONSIDERATION OF SHAREHOLDERS' AND EMPLOYEES' VIEWS

The Group is committed to regular dialogue with stakeholders. In formulating the policy, the Remuneration Committee has consulted extensively with a number of shareholders and key stakeholders, such as the Group's main regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The following topics were discussed:

-Alignment of variable remuneration to Group strategic priorities

-Structure of variable remuneration

-Latest regulatory requirements

-Latest shareholder guidelines

Formal consultation on the remuneration of Executive Directors is not undertaken with employees and no formal remuneration comparison measurements were used. However, surveys are undertaken semi-annually on employee engagement and discussion on the Group's remuneration approach takes place with union representatives during the annual pay review cycle and on relevant employee reward matters, on which the Remuneration Committee receives and considers relevant feedback. In addition, the Remuneration Committee has reviewed equal pay analysis undertaken by an independent third party and will continue to monitor this on an ongoing basis.

Colleague opinion is also sought through regular engagement surveys. This includes questions relating to remuneration, the results of which in 2016 positioned colleague satisfaction with the Group's reward arrangements, including the link to performance, above the high performing norm of UK companies.

## REMUNERATION POLICY TABLE FOR EXECUTIVE DIRECTORS

### BASE SALARY

<b>Purpose and link to strategy</b>	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.
<b>Operation</b>	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: <ul style="list-style-type: none"><li>- An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies.</li></ul>

- 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.

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.

**Maximum potential**

**Performance measures**

N/A

COMPENSATION

**Changes** Previously, the Group Chief Executive (GCE) had a reference salary of £1.22 million which was used to calculate certain elements of long-term remuneration and the pension allowance. Due to the GCE's base salary being increased to his reference salary (effective from 1 January 2017), the concept of reference salary is being removed. Elements of long-term remuneration and the pension allowance which were previously calculated with regard to reference salary will be calculated with regard to the GCE's base salary.

**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 Performance measures Changes**

The maximum award is 100 per cent of base salary.

N/A

No change to policy

**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.

**Performance measures**

N/A

**Changes**

No change to policy for existing Executive Directors. All future appointments as Executive Directors will attract a maximum allowance of 25 per cent of base salary.

**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.

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.

**Maximum potential**

**Performance measures**

N/A

**Changes**

No change to policy

**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.

Participation levels may be increased up to HMRC limits as amended from time to time.

**Maximum potential**

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

**Changes**

No change to policy

## COMPENSATION

**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 an event occurring 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 Performance measures**

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.

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 2017 financial year are set out on page 136. 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.

**Changes**

Due to regulatory changes, Executive Directors can no longer receive dividend equivalents on deferred shares. The number of shares to be awarded may be calculated using a fair or discounted value. If regulatory requirements change, dividend equivalents may be paid. There are no changes to maximum opportunity.

**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 an event occurring 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.

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.

**Maximum  
potential**

128

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.

**Changes** Due to regulatory changes, Executive Directors can no longer receive dividend equivalents on deferred shares. The number of shares to be awarded may be calculated using a fair or discounted value. If regulatory requirements change, dividend equivalents may be paid. There are no changes to maximum opportunity.

**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.

**Changes** The deferral period has been extended to comply with new 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.

**DISCRETION IN RELATION TO GROUP PERFORMANCE SHARE AND GROUP OWNERSHIP SHARE PLANS**

The Committee retains discretion with regards to these plans. This relates to:

-the timing, size and type of awards and holding periods, subject to policy maxima;

adjustments required in certain circumstances (e.g. rights issues, corporate restructuring events and special dividends);

where qualitative performance measures are used and performance against those measures is not commensurate with the Group's overall financial performance over the performance period;

adjustment of targets and measures if events occur which cause it to determine that the conditions are no longer appropriate. The Committee also retains the right to change performance targets and measures and the weighting of measures, including following feedback from regulators, shareholders and/or other stakeholders; and

amending the plan rules in accordance with their terms.

The exercise of the Committee's discretion will be disclosed in accordance with regulatory requirements.

## **LEGACY AWARDS AND RESTRICTIONS ON PAYMENTS**

The Committee reserves the right to make any remuneration payments/awards and any payments/awards for loss of office, notwithstanding that they are not in line with the policy set out above where the terms of the payment/award were agreed (i) before the Directors' remuneration policy approved by shareholders on 15 May 2014 (the '2014 policy') came into effect; (ii) pursuant to the 2014 policy; or (iii) at a time when the relevant individual was not a Director of the Group and, in the opinion of the Committee, the payment/award was not in consideration for the individual becoming a Director of the Group. Such payments/awards will have been set out in the annual report on remuneration for the relevant year. They include awards and payments made under previous approved remuneration policy and payments in relation to deferred bonus awards and long-term incentive awards granted in 2012 and 2013.

## **ILLUSTRATION OF APPLICATION OF REMUNERATION POLICY**

The charts below illustrate possible remuneration outcomes under the following three scenarios:

1. The maximum that may be paid, assuming full Group Performance Share payout and full vesting under the Group Ownership Share plan.

2. The expected value of remuneration for performance midway between threshold and maximum, assuming 30 per cent of maximum Group Performance Share opportunity and 50 per cent vesting under the Group Ownership Share plan.

3. The minimum that may be paid, where only the fixed element is paid (salary, benefits, pension and the fixed share award).

## COMPENSATION

No share price growth has been assumed. The amounts are based on salaries as at 1 January 2017 (GCE and CRO) and 1 April 2017 (CFO) and implementation of the policy in 2017 as set out in the annual report on remuneration.

### **António Horta-Osório**

*Value of package (£000)*

### **George Culmer**

*Value of package (£000)*

### **Juan Colombás**

*Value of package (£000)*

## **APPROACH TO RECRUITMENT AND APPOINTMENT TO THE BOARD**

In determining appropriate remuneration arrangements on hiring a new Executive Director, the Committee will take into account all relevant factors. This may include the experience and calibre of the individual, local market practice, the existing remuneration arrangements for other executives and the business circumstances. The Committee will seek to ensure that arrangements are in the best interests of both the Group and its shareholders and will seek not to pay more than is necessary.

The Committee may make awards on hiring an external candidate to 'buy-out' remuneration arrangements forfeited on leaving a previous employer. In doing so the Committee will take account of relevant factors including any performance conditions attached to these awards, the form in which they were granted (e.g. cash or shares), the

currency of the awards, and the timeframe of awards. Any such award made will be made in accordance with the PRA's Rulebook and made on a comparable basis to those forfeited and subject to malus and clawback at the request of the previous employer as required by the PRA rules.

The package will normally be aligned with the remuneration policy as described in the policy report. However, the Committee retains the discretion to make appropriate remuneration decisions outside the standard policy to facilitate the recruitment of an individual of the calibre required and in exceptional cases.

This may, for example, include the following circumstances:

–An interim recruit, appointed to fill an Executive Director role on a short-term basis.

–Exceptional circumstances requiring the Chairman to take on an executive function on a short-term basis.

An Executive Director recruited at a time in the year when it would be inappropriate to provide a Group Performance Share or Group Ownership Share award for that year, for example, where there may be insufficient time to assess performance. In this situation the Committee may feel it appropriate to transfer the quantum in respect of the months employed during the year to the subsequent year so that reward is provided on a fair basis.

An Executive Director recruited from a business or location where benefits are provided that do not fall into the definition of 'variable remuneration forfeited' but where the Committee considers it reasonable to buy-out these benefits.

– Transitional arrangements for overseas hires, which might include relocation expenses and accommodation.

The maximum level of variable remuneration (excluding buy-out awards) that may be awarded to new Executive Directors is equal to 200 per cent of fixed remuneration, including any discount permitted by the European Banking Authority for Group Ownership Share awards. In making any such remuneration decisions, the Committee will apply any appropriate performance measures in line with those applied to other Executive Directors.

A full explanation will be provided of any buy-out award or discretionary payment.

## COMPENSATION

**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.

	<b>Notice to be given by the Group</b>	<b>Date of service agreement</b>
Lord Blackwell	6 months	31 March 2014
António Horta-Osório	12 months	3 November 2010
George Culmer	12 months	1 March 2012
Juan Colombás	12 months	30 November 2010

Under his contract (dated 3 November 2010), António Horta-Osório (GCE) is entitled to an amount equivalent to base salary and pension allowance as a payment in lieu of notice if notice to terminate is given by the Group. If notice to terminate is given by the GCE, he is entitled to an amount equivalent to base salary if the Group chooses to make a payment in lieu of notice. Such payments in lieu will be made in monthly instalments subject to mitigation. He is also entitled to six months' notice from the Group in the event of his long-term incapacity. As part of a buy-out of a pension forfeited on joining from Santander, the GCE is also entitled to the provision of a conditional unfunded pension commitment, subject to performance conditions as described further in the annual report on remuneration. In the event of long-term incapacity, if the GCE does not perform his duties for a period of at least 26 weeks (in aggregate over a 12 month period), the Group shall be entitled to terminate his employment by giving six months' notice. In all other respects, the terms of the GCE's contract in relation to payments for loss of office match those set out below for new directors.

Under terms agreed when joining the Group, Juan Colombás is entitled to a conditional lump sum benefit, payable either (i) on reaching normal retirement age unless he voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death, as described further in the annual report on remuneration.

The service contracts and letters of appointment are available for inspection at the Company's registered office.

**NOTICE PERIODS**

Newly-appointed Executive Directors will be employed on contracts that include the following provisions:

The individual will be required to give six months' notice if they wish to leave and the Group will give 12 months' notice other than for material misconduct or neglect or other circumstances where the individual may be summarily dismissed by written notice. In exceptional circumstances, new joiners will be offered a longer notice period (typically reducing to 12 months within two years of joining).

In the event of long-term incapacity, if the Executive Director does not perform their duties for a period of at least 26 weeks (in aggregate over a 12 month period), the Group shall be entitled to terminate the executive's employment by giving three months' notice.

At any time after notice to terminate is given by either the Group or the Executive Director, the Group may require the Executive Director to take leave for some or all of the notice period.

At any time, at its absolute discretion, the Group may elect to terminate the individual's employment by paying to the Executive Director, in lieu of the notice period, an amount equivalent to base salary, subject to mitigation as described more fully in the termination payments section of this report, below.

131

## 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 employment, paid for the	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	Paid until date of death/retirement (subject to individual benefit scheme rules). For ill health, injury, permanent



Edgar Filing: Lloyds Banking Group plc - Form 20-F

	applicable notice period (including any period of leave required by the Group).	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. 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.	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		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

	Annual bonus (now known as Group Performance Share) <sup>1</sup>	Long-term incentive (now known as Group Ownership Share) <sup>2</sup>	Chairman and Non-Executive Director fees <sup>3</sup>
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 <sup>2</sup>	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	Paid until date of leaving Board.

exchanged for equivalent awards over 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.
---	--	--	-----------------------------------

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).

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.

<sup>3</sup>The Chairman is entitled to six months' notice.

## COMPENSATION

On termination, the Executive Director will be entitled to payment for any accrued but untaken holiday calculated by reference to base salary and fixed share award.

The cost of legal, tax or other advice incurred by an Executive Director in connection with the termination of their employment and/or the cost of support in seeking alternative employment may be met up to a maximum of £100,000. Additional payments may be made where required to settle legal disputes, or as consideration for new or amended post-employment restrictions.

Where an Executive Director is in receipt of expatriate or relocation expenses at the time of termination (as at the date of the AGM no current Executive Directors are in receipt of such expenses), the cost of actual expenses incurred may continue to be reimbursed for up to 12 months after termination or, at the Group's discretion, a one-off payment may be made to cover the costs of premature cancellation. The cost of repatriation may also be covered.

## REMUNERATION POLICY TABLE FOR CHAIRMAN AND NON-EXECUTIVE DIRECTORS

The table below sets out the remuneration policy for Non-Executive Directors (NEDs).

### CHAIRMAN AND NON-EXECUTIVE DIRECTOR FEES

<b>Purpose and link to strategy</b>	To provide an appropriate reward to attract and retain a high-calibre individual with the relevant skills, knowledge and experience.
<b>Operation</b>	<p>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.</p> <p>When determining and reviewing fee and benefit levels, the Committee ensures that decisions are made within the following parameters:</p> <ul style="list-style-type: none"><li>The individual's skills and experience.</li><li>An objective assessment of the individual's responsibilities and the size and scope of their role, using objective sizing methodologies.</li><li>Fees and benefits for comparable roles in comparable publicly listed financial services groups of a similar size.</li></ul> <p>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</p>

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

**Changes**

No change to policy.

**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.

**DATE OF LETTER OF APPOINTMENT**

Alan Dickinson	26 June 2014	Deborah McWhinney	26 November 2015
Anita Frew	17 November 2010	Nick Prettejohn	1 April 2014
Simon Henry	1 May 2014	Stuart Sinclair	26 November 2015
Dyfrig John	28 October 2013	Anthony Watson	23 February 2009
Nick Luff	25 February 2013	Sara Weller	31 January 2012

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

**ANNUAL REPORT ON REMUNERATION**

**IMPLEMENTATION OF THE POLICY IN 2017**

It is proposed to operate the policy in the following way in 2017:

**BASE SALARY**

The Group has applied a 2 per cent overall salary budget increase for the general population differentiated by performance and market position (with increases of around 4 per cent for strongly performing colleagues). Salary increases of 2 per cent are proposed for the Chief Financial Officer (CFO) and the Chief Risk Officer (CRO).

As announced last year, for the first time since 2011 a salary increase was applied in 2016 for the Group Chief Executive to begin to adjust his base salary to the previously disclosed reference salary of £1,220,000 which was set relative to the market when he joined in 2011. After discussing the proposed increase with shareholders, the Remuneration Committee decided to stage the adjustment over two years, with an initial increase to £1,125,000 effective from 1 January 2016 and the second stage increase to £1,220,000 due to be implemented with effect from 1 January 2017. The form of the increase will follow that for 2016, with 2 per cent delivered in cash (in line with other colleagues) and the remainder in shares, held until the government has sold its shareholding in the Group.

Salaries will therefore be as follows, effective dates shown below:

GCE: £1,220,000 (1 January 2017)

CFO: £764,070 (1 April 2017)

CRO: £753,458 (1 January 2017)

Due to the GCE's base salary being increased in line with his reference salary (effective from 1 January 2017), the concept of a separate reference salary will be removed. Reference salary will therefore no longer be used when calculating certain elements of long-term remuneration and the pension allowance. Instead, these elements will be calculated with reference to the GCE's base salary.

## **FIXED SHARE AWARD**

The levels of the 2017 award are unchanged from 2016 and are as follows:

GCE: £900,000

CFO: £504,000

CRO: £497,000

Shares will be released in equal tranches over a five year period.

## **PENSION**

Executive Directors are entitled to a pension allowance which they may choose to take as cash in lieu of pension contributions.

The level of allowances has not been increased for 2017.

GCE: 50 per cent of base salary less flexible benefits allowance

CFO: 25 per cent of base salary

CRO: 25 per cent of base salary

## **BENEFITS**

For 2017, 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 2016).

## ALL-EMPLOYEE PLANS

Executive Directors are eligible to participate in the Group's Sharesave and Sharematch plans on the same basis as other employees.

## GROUP PERFORMANCE SHARE PLAN

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 (unchanged from 2016). All assessments of **Opportunity** performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance for the financial measure is not met and/or the individual is rated 'Developing performer' or below. The threshold is set at 20 per cent below the Group's underlying profit target.

For the 2017 performance year, the Group Performance Share opportunity will be awarded 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 holding period in line with regulatory requirements and market practice.

**Deferral**

135



## COMPENSATION

### **Performance measures and targets**

For 2017, the Group Performance Share will be based on a percentage of the Group's underlying profit, adjusted by a strategic multiplier of up to 130 per cent based on the Group's Balanced Scorecard (BSC) metrics and risk matters.

In 2017, at least 75 per cent of performance is weighted towards a financial measure.

Individual awards are adjusted to reflect a balanced scorecard approach with clearly identified performance metrics used to assess Group performance in key areas. Stretching objectives for each division and function 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 and divisional/functional 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', which is the highest rating. 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.

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 bonus 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 bonus 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 bonus 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.

## **GROUP OWNERSHIP SHARE PLAN**

### **Opportunity**

The maximum Group Ownership Share award for Executive Directors is 300 per cent of salary (unchanged from 2016). Awards in 2017 are being made as follows:

GCE: 300 per cent of reference salary

CFO: 275 per cent of base salary

CRO: 275 per cent of base salary

### **Performance measures and targets**

2017 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.

During 2016 and early 2017, the Committee consulted widely with shareholders on appropriate performance measures, particularly the link between performance measures and the Group's strategic priorities.

The awards made in 2017 will vest based on the Group's performance against the following key financial and strategic measures:

- Absolute Total Shareholder Return (30 per cent)
- Economic profit (25 per cent)
- Cost:income ratio (10 per cent)
- Strategic measures (35 per cent))

The following table provides a breakdown of these measures and the targets applicable.

The Committee believes that these measures appropriately capture risk management and long-term sustainable growth, aligning management and shareholder interests. Each of the measures aligns to the reward principles and, through that, the Group's strategic priorities.

Awards are 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. The Committee may consider the application of malus and clawback as outlined in the Group Performance Share plan section above.

## COMPENSATION

Strategic priorities	Measure	Basis of payout range	Metric	Weighting
<b>Creating the best customer experience</b>	FCA total reportable complaints per 1,000 accounts <sup>1</sup> and	Set relative to 2019 targets	See note 1 below	10%
	Financial Ombudsman Service (FOS) uphold rate (excl PPI)	Average rates 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%
<b>Becoming simpler and more efficient</b>	Economic profit <sup>2</sup>	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%
<b>Delivering sustainable growth</b>	Absolute Total Shareholder Return (TSR)	Growth in share price including dividends over three-year period	Threshold: 8% Maximum: 16%	30%
<b>Building the best team</b>	Employee engagement index	Set relative to 2019 targets	Threshold: 67% Maximum: 73%	7.5%

The FCA changed the approach to complaint classification and reporting from 30 June 2016. Updated complaint 1 data is not yet available on the new basis, but will be available by the end of the first quarter at which point, or shortly thereafter, the metric will be disclosed.

<sup>2</sup>A measure of profit taking into account Expected Losses, tax and a charge for equity utilisation.

**CHAIRMAN AND NON-EXECUTIVE DIRECTOR FEES IN 2017**

The annual fee for the Chairman was increased by 2 per cent to £728,280, in line with the overall salary budget for the general colleague population.

Edgar Filing: Lloyds Banking Group plc - Form 20-F

The annual Non-Executive Director fees were reviewed and as result of this review some of the fees were increased, as follows, to reflect market practice in financial services groups of a similar size. These changes took effect from 1 January 2017.

	<b>2017</b>	<b>2016</b>
Basic Non-Executive Director fee	<b>£76,500</b>	£75,000
Deputy Chairman	<b>£100,000</b>	£100,000
Senior Independent Director	<b>£60,000</b>	£60,000
Audit Committee Chairmanship	<b>£70,000</b>	£60,000
Remuneration Committee Chairmanship	<b>£70,000</b>	£60,000
Board Risk Committee Chairmanship	<b>£70,000</b>	£60,000
Responsible Business Committee Chairmanship	<b>£40,000</b>	£40,000 <sup>4</sup>
Audit Committee membership	<b>£32,000</b>	£30,000
Remuneration Committee membership	<b>£32,000</b>	£30,000
Board Risk Committee membership	<b>£32,000</b>	£30,000
Responsible Business Committee members	<b>£15,000<sup>1</sup></b>	£10,000 <sup>1</sup>
Nomination and Governance Committee membership	<b>£15,000<sup>2</sup></b>	£5,000 <sup>3</sup>

1 New members only.

2 Including payments to Chairmen of other Committees who are members.

3 Where individual was not Chairman of another Committee.

4 During 2016, the fee for Chairmanship of the Responsible Business Committee increased from £30,000 to £40,000.

Non-Executive Directors may receive more than one of the above fees.

## COMPENSATION

## REMUNERATION OUTCOME FOR 2016

## EXECUTIVE DIRECTORS (AUDITED)

The following table summarises the total remuneration delivered during 2016 in relation to service as an Executive Director.

£000	António Horta-Osório <sup>1</sup>		George Culmer		Juan Colombás		Totals	
	2016	2015	2016	2015	2016	2015	2016	2015
Base salary	1,125	1,061	745	731	739	724	2,609	2,516
Fixed share award	900	900	504	504	497	497	1,901	1,901
Benefits	143	140	42	41	70	73	255	254
Other remuneration <sup>2</sup>	1	2	1	2	1	2	3	6
Annual bonus	1,220	850	574	462	578	455	2,372	1,767
Long-term incentive <sup>3</sup>	1,584	5,183	857	2,804	763	2,496	3,204	10,483
Pension allowance <sup>4</sup>	568	568	186	182	185	181	939	931
<b>Total remuneration</b>	<b>5,541</b>	<b>8,704</b>	<b>2,909</b>	<b>4,726</b>	<b>2,833</b>	<b>4,428</b>	<b>11,283</b>	<b>17,858</b>
Less: performance adjustment <sup>5</sup>	–	(234 )	–	(65 )	–	(3 )	–	(302 )
<b>Total remuneration less performance adjustment</b>	<b>5,541</b>	<b>8,470</b>	<b>2,909</b>	<b>4,661</b>	<b>2,833</b>	<b>4,425</b>	<b>11,283</b>	<b>17,556</b>

<sup>1</sup> 2016 base salary increase: 6 per cent (2 per cent in cash and the remainder in shares, held until the government has sold its shareholding in the Group).

<sup>2</sup> Other remuneration payments comprise income from all employee share plans, which arises through employer matching or discounting of employee purchases.

The LTIP vesting and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 15 February 2017. The average share price between 1 October 2016 and 31 December 2016 (58.30 pence) has been used to indicate the value. The shares were awarded in 2014 based on a share price of 78.878 pence. LTIP and dividend equivalent figures for 2015 have been adjusted for the share price on the date of vesting (72.75 pence).

Following changes to the amount of tax relief available on pension contributions in each year, Executive Directors may elect to receive some or all of their allowances as cash. The breakdown of payments made in cash and contributions into the pension scheme are shown below.

<sup>5</sup> In June 2015, the Group reached a settlement with the Financial Conduct Authority (FCA) with regard to aspects of its Payment Protection Insurance (PPI) complaint handling process during the period March 2012 to May 2013. As a result, the Committee decided to make performance adjustments in respect of bonuses awarded in 2012 and 2013 to

the Group Executive Committee and some other senior executives given their ultimate oversight of the PPI operations. The number of shares adjusted was 409,039 for the Group Chief Executive (GCE), 109,464 for the Chief Financial Officer (CFO) and 376,055 for the Chief Risk Officer (CRO) (pro-rated in the above table to reflect his appointment to Executive Director on 29 November 2013). The share price used for the valuation was the market price for a share in the Group at the award dates, 49.29 pence and 78.878 pence, respectively.

## PENSION AND BENEFITS (AUDITED)

<b>Pension/Benefit £</b>	<b>António Horta-Osório</b>	<b>George Culmer</b>	<b>Juan Colombás</b>
Employer contribution to pension scheme	9,542	4,492	12,068
Cash allowance in lieu of pension contribution	558,018	181,862	172,711
Car or car allowance	12,000	12,183	12,000
Flexible benefits payments	42,440	29,376	28,968
Private medical insurance	30,950	760	14,068
Tax preparation	24,000	–	11,940
Transportation	33,760	–	2,900

## DEFINED BENEFIT PENSION ARRANGEMENTS (AUDITED)

The GCE 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 EFRBS applies for a maximum of six years following the commencement of employment and the maximum allowance over that period is 26.5 per cent of the higher of the GCE's base salary or reference salary in the 12 months before retirement or leaving, subject to performance conditions. No additional benefit is due in the event of early retirement. The rate of pension accrual in each year depends on share price conditions being met. Accrual at 31 December 2016 is a pension of 6 per cent of the reference salary or £73,200. No new pension entitlement was accrued in 2016.

There are no other Executive Directors with defined benefit pension entitlements.

Under terms agreed when joining the Group, the CRO is entitled to a conditional lump sum benefit of £718,996 either (i) on reaching normal retirement age unless the CRO voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death.

## 2014 LTIP VESTING (AUDITED)

	Number		Number	Indicative	Indicative	Indicative	
	of shares awarded	Vesting % <sup>1</sup>	of shares	share price	value of	dividend	Indicative
			vesting	at vesting	award	equivalent	total value
António Horta-Osório	4,640,077	55%	2,552,042	58.30 pence	£1,487,840	£95,940	£1,583,780
George Culmer	2,510,205	55%	1,380,612	58.30 pence	£804,897	£51,902	£856,799
Juan Colombás	2,234,780	55%	1,229,129	58.30 pence	£716,582	£46,207	£762,789

<sup>1</sup> For details of the performance outcome please refer to section 'Long-term awards made in March 2014 vesting for the period ended on 31 December 2016'.

138



## COMPENSATION

### ANNUAL BONUS (AUDITED)

The individual bonus awards for Executive Directors are determined in the same way as for colleagues across the Group, with outcomes based on the individual on-target award adjusted for the Group annual bonus outcome and for individual performance outcomes.

The Group total bonus outcome is the sum of the divisional and functional bonus outcomes. Performance outcomes are determined by adjusting the Group's target bonus outcome according to Group underlying profit and Balanced Scorecard performance. These are each used as a modifier to increase or decrease the target bonus outcome in the range of 0 per cent – 145 per cent, subject to an overall funding limit of 10 per cent of pre-bonus underlying profit. A collective performance adjustment is then applied.

The individual on-target award is then adjusted for the Group annual bonus outcome and for individual performance outcomes. Awards are approved by the Committee, which has discretion to adjust outcomes for any reason.

The approach to determining annual bonus awards is summarised below:

### ANNUAL BONUS OUTCOME FOR 2016 (AUDITED)

The target bonus outcome for 2016 (£397.1 million) was adjusted for:

#### *(1) Group underlying profit performance*

A target of £7,572 million was approved by the Board. In line with regulatory requirements, the underlying profit of £7,867 million has been adjusted by the incremental movement in Prudential Valuation Adjustment (PVA) from year-end 2015 to year-end 2016. The adjustment of £126 million reduces the underlying profit figure to £7,741 million, resulting in a modifier of 1.22.

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.

139

## COMPENSATION

### APPROACH TO THE BALANCED SCORECARD (BSC)

Each measure in the Group and divisional/functional 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', which is the highest rating. Each of these ratings may be further differentiated by the addition of 'minus' or 'plus'. The Committee reviewed performance in depth to determine ratings for the Group and each division and function, including consideration of risk matters arising in 2016. Risk adjustments were approved by the Board Risk Committee.

The ratings for each division and function are communicated to all colleagues within the business area to ensure bonus outcomes are transparent and understood. The ratings are considered commercially sensitive; however, as an indication of performance, the overall rating for the Group (as determined by the Committee) was Strong plus and the average of the divisional/functional modifiers applied was 1.26.

Key performance factors considered by the Committee in arriving at the performance assessment for the Group included:

<b>Strong financial performance</b>	Underlying profit was £7.9 billion and statutory profit has more than doubled to £3.9 billion. Despite an additional PPI provision and the challenging macroeconomic environment, the Group remains strongly capital generative with an adjusted CET1 ratio of 13.7 per cent after increased dividend.
<b>Growth in the key customer segments</b>	The Group continued to make good progress in growing market share in areas where it is under represented, growing lending to SME clients and in consumer finance.
<b>Lower risk bank</b>	Continued efforts to de-risk the bank, combined with sustained improvements in core prudential risks (capital, credit, funding) and a customer centric culture are delivering a lower risk bank. From a credit perspective, asset quality remained strong with no deterioration in the underlying portfolio. Prudent risk appetite and robust risk management framework reflected in lower impaired loans and an improved impaired loan ratio.
<b>Effective cost leadership</b>	Cost management remains a strategic priority and the acceleration of cost initiatives in response to the lower interest rate environment has enabled the Group to reduce operating costs by 3 per cent. The market leading cost:income ratio also improved to 48.7 per cent.
<b>Increased dividends</b>	Increased ordinary dividend of 2.55 pence per share in 2016 (2015: 2.25 pence), in line with the Group's progressive and sustainable dividend policy. Additional special dividend of 0.5 pence.
<b>PRA stress test threshold exceeded</b>	The resilience of the Group's capital position was demonstrated again in 2016 when it comfortably exceeded the threshold for the latest PRA stress test and performed well compared to peers.
<b>Customer focus in the business</b>	Development and launch of the Customer Journey framework and strategy which will be the basis to manage the Group and its control environment in a customer centric way. Further reductions in the level of customer complaints. Net promotor score continued to improve and is now nearly 50 per cent higher than at the end of 2011.
<b>Culture and reputation</b>	Accelerated progress towards the desired culture, developing new Management Information, further embedding the Group Customer First Committee and the work to establish the Customer Journey strategy.
	The Group's reputation with external stakeholders.

*(3) Collective performance adjustment*

Consideration was given to items not factored into the Group underlying profit or divisional or functional Balanced Scorecards. These included the provisions for legacy conduct-related matters relevant to the year. As a result of these items, the Committee approved an overall collective adjustment of £91.2 million or approximately 19 per cent, resulting in a final bonus outcome of £392.9 million as shown in the table below. The bonus outcome of £392.9 million is significantly below the overall funding limit of 10 per cent of pre bonus underlying profit.

TOTAL BONUS OUTCOME

COMPENSATION

INDIVIDUAL OUTCOMES FOR EXECUTIVE DIRECTORS (AUDITED)

The individual bonus awards for Executive Directors are determined in the same way as for colleagues across the Group, with outcomes based on annual bonus outcome, weighted by:

1. Individual performance
2. On-target award

Awards are approved by the Committee, which has discretion to adjust outcomes for any reason.

ANTÓNIO HORTA-OSÓRIO

The Group Chief Executive's (GCE) individual performance assessment for 2016, as confirmed by the Committee, reflected the Group's performance as outlined on page 140 and a number of other considerations including:

<b>Strong financial performance</b>	Improvement in market-leading cost:income ratio delivered, with statutory profit more than doubled and key balance sheet metrics strengthened.
<b>Low risk business model maintained</b>	Continued improvement in credit quality of lending portfolio, strong performance in 2016 PRA stress test.
<b>Increased dividends</b>	Increase in ordinary dividend to 2.55 pence per share (2015: 2.25 pence) in line with the Group's progressive and sustainable dividend policy, with additional special dividend of 0.5 pence per share.
<b>Strong employee engagement</b>	Employee engagement survey results strengthened despite uncertain economic outlook and announcement of further role reductions – scores significantly higher than UK benchmark and close to UK high-performing benchmark.
<b>Creating the best customer experience</b>	Key Customer Journeys across retail and commercial banking and insurance significantly enhanced, leading to improved customer feedback and trust scores as well as complaints reducing from their low levels relative to the sector.
<b>Continued growth in digital channels</b>	With 12.5 million online and 8 million mobile banking customers, the Group operates the UK's largest digital bank, and now meets over 60 per cent of customers' banking needs digitally.
<b>Supporting the UK economy and helping Britain prosper</b>	Remaining the largest lender to first-time buyers and maintaining the recent record of above-market growth in lending to SMEs. Commitments to support communities and charities also exceeded.

<b>Leading the Group's strategic development</b>	Lead Board and executive team in highly impactful exercise to review the impact of digital technology and market change on the 'Bank of the Future', enabling the Group to develop critically important plans for the evolution of its business model and technology base.
<b>UKFI reduction in government shareholding</b>	Continued successful delivery of the Group's strategy enabling a significant reduction in the government shareholding to less than 5 per cent. UKFI no longer the Group's largest shareholder, with £18.5 billion now having been returned to the UK taxpayer at a profit.

Based on a full assessment of performance, the Committee agreed an individual rating for 2016 of Strong plus for the GCE, an improvement from Strong in 2015.

Expected outcomes are based on individual performance before taking into account a modifier based on underlying profit and the Group BSC, as follows:

<b>Rating</b>	<b>Under</b>	<b>Developing</b>	<b>Good</b>	<b>Strong</b>	<b>Top</b>
Expected outcome as % of salary	0%	0%	42%	91%	140%

Following the Committee's assessment of performance against the underlying profit target and Group BSC objectives, and taking into account the collective performance adjustment of 19 per cent and the improvement to the individual rating of Strong plus, the Committee determined a 2016 bonus award for the GCE of £1,219,537 (108 per cent of salary and 77 per cent of maximum).

GEORGE CULMER

The Chief Financial Officer's (CFO) personal performance assessment for 2016, as confirmed by the Committee, reflected a number of considerations including:

<b>Strong financial performance</b>	Strong financial performance delivered in challenging low interest rate and volatile market environment – key liquidity, funding and capital metrics either strengthened or maintained.
<b>Cost leadership</b>	Continued improvement in the Group's market-leading cost:income ratio to 48.7 per cent (2015: 49.3 per cent) – efficiency programme successfully accelerated in response to customers' changing preferences.
<b>Strong capital generation</b>	Group's adjusted CET1 capital ratio of 13.7 per cent comfortably above regulatory requirements after increased ordinary dividend of 2.55 pence per share and an additional special dividend of 0.5 pence per share.
<b>Resilient business model</b>	'Stressed' CET1 capital and leverage ratios of 10.3 per cent and 4.3 per cent from 2016 regulatory (PRA) stress test comfortably above regulatory requirements and strongest across major UK banking peers.

<b>Successful outcome of ECN court case</b>	Successful outcome of ECN ('enhanced capital notes') court case – enabling the Group to improve the efficiency of its balance sheet and reduce funding costs.
<b>Well managed external stakeholder relations</b>	Well-managed relationships with key external stakeholders, e.g. debt and equity investors, regulators, and credit rating agencies.

141

## COMPENSATION

Based on a full assessment of performance, the Committee agreed an individual rating for 2016 of Strong plus for the CFO. Expected outcomes are based on individual performance before taking into account a modifier based on underlying profit and the Finance division's BSC, as follows:

<b>Rating</b>	<b>Under Developing Good Strong Top</b>				
Expected outcome as % of salary	0%	0%	30%	65%	100%

Following the Committee's assessment of performance against the underlying profit target and the Finance division's BSC objectives, and taking into account the collective performance adjustment of 19 per cent and the individual rating of Strong plus, the Committee determined a 2016 bonus award for the CFO of £574,326 (77 per cent of maximum).

## JUAN COLOMBÁS

The Chief Risk Officer's (CRO) personal performance assessment for 2016, as confirmed by the Committee, reflected a number of considerations including:

<b>Strong risk management framework</b>	The Group remains comfortably within risk appetite set by the Board, with strengthened processes and controls, aligning to the Group's objective of being a low risk bank.
<b>Strengthened management of operational risk</b>	Management of operational risk strengthened through the development of a robust control framework for key risk categories.
<b>Credit quality</b>	Prudent lending criteria reflected in credit quality across all lending portfolios and reduced gross impairment charges.
<b>Low risk culture and effective controls</b>	Low risk culture and effective controls reflected in very low level of financial losses following EU Referendum result and other periods of market volatility.
<b>Effective optimisation of balance sheet</b>	Effective optimisation of balance sheet leading to further reductions in risk-weighted assets (RWAs) – in turn supporting capital generation.
<b>Low risk model recognised by the market</b>	Group's low risk model recognised by the market; tight credit default swap (CDS) spreads and resilient credit ratings confer tangible funding cost benefits to the Group.

Based on a full assessment of performance, the Committee agreed an individual rating for 2016 of Strong plus for the CRO.

Expected outcomes are based on individual performance, before taking into account a modifier based on underlying profit and the Risk division's BSC, as follows:



<b>Rating</b>	<b>Under</b>	<b>Developing</b>	<b>Good</b>	<b>Strong</b>	<b>Top</b>
Expected outcome as % of salary	0%	0%	30%	65%	100%

Following the Committee's assessment of performance against the underlying profit target and the Risk division's BSC objectives, and taking into account the collective performance adjustment of 19 per cent and the individual rating of Strong plus, the Committee determined a 2016 bonus award for the CRO of £577,676 (78 per cent of maximum).

## DEFERRAL

The 2016 annual bonus for all Executive Directors is awarded in a combination of cash and shares. 40 per cent of the annual bonus will be released in 2017 (£2,000 cash in March, the remainder in shares), 40 per cent will be released in 2018 and the remaining 20 per cent will be released in 2019, 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 that otherwise would have been earned, if it deems appropriate as a result of an event occurring before vesting.

## LONG-TERM AWARDS MADE IN MARCH 2014 VESTING FOR THE PERIOD ENDED ON 31 DECEMBER 2016 (AUDITED)

Awards (in the form of conditional rights to free shares) in 2014 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.

## COMPENSATION

The Group has delivered a good financial performance over the performance period of the 2014 Long-Term Incentive Plan (LTIP) awards, continuing to transform the business for the benefit of our shareholders. Performance was measured over three financial years ended 31 December 2016. The performance conditions attached to these awards and actual performance are set out in the table below. At the end of the performance period, it has been assessed that awards will vest at 55 per cent of maximum. Executive Directors are required to retain any shares vesting for a further two years post vesting.

## 1 Adjusted total costs.

2 FCA reportable complaints per 1,000 for the period up to and including H1 2016 and formally closed FCA complaints per 1,000 accounts for the period from H2 2016. Both exclude PPI complaints, any complaints received via Claims Management Companies (CMC) and any complaints relating to TSB activity. With the introduction of the FCA guidance contained in PS15/19 applicable from 1 July 2016, the complaint classification and reporting for the original metric ceased on 30 June 2016. Accordingly, the Remuneration Committee has rebased the original 2014 metrics in line with the new FCA reporting regime. The Remuneration Committee considers the rebased targets equally stretching.

**PERCENTAGE CHANGE IN REMUNERATION OF THE GROUP CHIEF EXECUTIVE VERSUS THE WIDER EMPLOYEE POPULATION**

Figures for 'All Employees' are calculated using figures for UK-based colleagues subject to the Group Annual Bonus 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 2016, 46,963 colleagues were included in this category.

	% change in base salary (2015 – 2016)	1	% change in bonus (2015 – 2016)	2	% change in benefits (2015 – 2016)	3
GCE	8.4%	1	44%	2	2%	
All employees	2%	3	17%	3	2%	3

12 per cent delivered in cash (in line with other colleagues) the remainder in shares.

2 The performance rating for the GCE improved from Strong in 2015 to Strong plus in 2016.

3 Adjusted for movements in staff numbers and other impacts to ensure a like-for-like comparison.

### **RELATIVE SPEND ON PAY (£M)**

The graph below illustrates the relative importance of spend on pay (total remuneration of all Group employees) compared with distributions to shareholders. Distributions to shareholders are ordinary and special dividends.

2016: Ordinary and special dividend in respect of the financial year ended 31 December 2016, partly paid in 2016 and partly to be paid in 2017. 2015: Ordinary and special dividend in respect of the financial year ended 31 December 2015, partly paid in 2015 and partly paid in 2016.

In addition to the annual bonus of £392.9 million awarded in respect of 2016 performance, the Group made Group Ownership Share awards of £47.6 million and paid approximately £84 million under variable pay arrangements used to incentivise customer-facing colleagues, primarily in the Retail division.

143

## COMPENSATION

**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 2016.

**EXTERNAL APPOINTMENTS HELD BY THE EXECUTIVE DIRECTORS**

António Horta-Osório – During the year ended 31 December 2016, the Group Chief Executive served as a Non-Executive Director of Exor, Fundação Champalimaud, Stichting INPAR and Sociedade Francisco Manuel dos Santos for which he received fees of £217,098 in total.

**CHAIRMAN AND NON-EXECUTIVE DIRECTORS (AUDITED)**

	Fees £000		Taxable benefits £000		Total £000	
	2016	2015	2016	2015	2016	2015
Chairman and current Non-Executive Directors						
Lord Blackwell	714	700	12 <sup>1</sup>	12 <sup>1</sup>	726	712
Alan Dickinson	195	144	–	–	195	144
Anita Frew	295	236	–	–	295	236
Simon Henry	135	105	–	–	135	105
Nick Luff	165	135	–	–	165	135
Deborah McWhinney	135	9	–	–	135	9
Nick Prettejohn	412	350	–	–	412	350
Stuart Sinclair	135	–	–	–	135	–
Anthony Watson	230	209	–	–	230	209
Sara Weller	171	135	–	–	171	135
Former Non-Executive Directors						
Carolyn Fairbairn (retired October 2015)	–	88	–	–	–	88
Dyfrig John (retired May 2016)	49	105	–	–	49	105
Total	2,636	2,216	12	12	2,648	2,228

1 Car allowance.

**BREAKDOWN OF NON-EXECUTIVE DIRECTORS' FEES (£000S)**

	<b>Board fee</b>	<b>Deputy Chairman</b>	<b>Senior Independent Director</b>	<b>Audit Committee</b>	<b>Remuneration Committee</b>	<b>Board Risk Committee</b>	<b>SWG Board fees<sup>1</sup></b>	<b>Other Committees</b>	<b>2016 Total</b>
Alan Dickinson <sup>2</sup>	75			30	30	60			195
Anita Frew <sup>2,3</sup>	75	100		30	60	30			295
Simon Henry	75			30		30			135
Dyfrig John	27				11	11			49
Nick Luff <sup>2</sup>	75			60		30			165
Deborah McWhinney	75			30		30			135
Nick Prettejohn	75			30		30	277		412
Stuart Sinclair	75				30	30			135
Anthony Watson	75		60	30	30	30		5 <sup>4</sup>	230
Sara Weller	75				30	30		36 <sup>5</sup>	171

<sup>1</sup> Scottish Widows Group Limited.

<sup>2</sup> Due to their role as Chairmen of other Board Committees, Alan Dickinson, Anita Frew and Nick Luff do not receive any fees for their membership of the Nomination and Governance Committee.

<sup>3</sup> As Deputy Chairman, Anita Frew does not receive any fee for membership of the Responsible Business Committee.

<sup>4</sup> Nomination and Governance Committee.

<sup>5</sup> Responsible Business Committee.

## COMPENSATION

**HISTORICAL TOTAL SHAREHOLDER RETURN (TSR) PERFORMANCE**

The chart below shows the historical TSR of Lloyds Banking Group plc compared with the FTSE 100 as required by the regulations, rebased as at 31 December 2008. 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.

## TOTAL SHAREHOLDER RETURN INDICES – LLOYDS BANKING GROUP AND FTSE 100

**HISTORICAL GROUP CHIEF EXECUTIVE (GCE) REMUNERATION OUTCOMES**

	GCE	2009	2010	2011	2012	2013	2014	2015	2016
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	5,541
Annual bonus payout	J E Daniels	Waived	62%	0%	–	–	–	–	–
(% of maximum opportunity)	António Horta-Osório	–	–	Waived	62%	71%	54%	57%	77%
Long-term incentive vesting	J E Daniels	0%	0%	0%	–	–	–	–	–
(% of maximum opportunity)	António Horta-Osório	–	–	0%	0%	54%	97%	94.18%	55%

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.

**OUTSTANDING SHARE AWARDS**

## DIRECTORS' INTERESTS (AUDITED)

## SHAREHOLDING GUIDELINES

Executive Directors were required to build up a holding in Lloyds Banking Group plc shares of value equal to 150 per cent of base salary (200 per cent for the GCE) within three years from the later of 1 January 2012 or their date of joining the Board. Following the introduction of the fixed share award in 2014, the gross annual value of this award was added to salary to determine the personal shareholding requirement.

For the purposes of assessing the additional shareholding requirement related to the fixed share award, Executive Directors had up to three years from 1 January 2014 to build up the additional shareholding created by the addition of the fixed share award. As at 31 December 2016, all Executive Directors significantly exceeded the requirements.

In order to provide greater transparency in the measurement of the shareholding requirements, from 1 January 2017 the measure is to be focused on base salary only. There will be a consequent increase in the percentage required as a multiple of salary; however the number of shares required to be held will remain approximately the same. 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.

Executive Directors are required to retain any shares vesting from 2014 LTIP awards onwards for a further two years post vesting (although vested shares count towards the shareholding requirement immediately after vesting).

## COMPENSATION

	Number of shares			Number of options		Total shareholding <sup>1</sup>		Value Expected value at 31 December 2016 (£000s) <sup>2</sup>
	Owning outright	Unvested subject to continued employment	Unvested subject to performance	Unvested subject to continued employment	Vested unexercised	Totals at 31 December 2016	Totals at 24 February 2017	
<b>Executive Directors</b>								
António Horta-Osório <sup>3</sup>	17,893,726	4,212,594	14,234,293	29,549	–	36,370,162	36,370,757 <sup>6</sup>	18,286
George Culmer	10,547,315	1,253,398	7,754,781	29,549	–	19,585,043	19,585,562 <sup>6</sup>	9,819
Juan Colombás	6,362,996	1,209,441	7,406,515	29,109	–	15,008,061	15,008,580 <sup>6</sup>	7,067
<b>Non-Executive Directors</b>								
Lord Blackwell	100,000	–	–	–	–	100,000	n/a <sup>6</sup>	n/a
Alan Dickinson	200,000	–	–	–	–	200,000	n/a <sup>6</sup>	n/a
Anita Frew	450,000	–	–	–	–	450,000	n/a <sup>6</sup>	n/a
Simon Henry	200,000	–	–	–	–	200,000	n/a <sup>6</sup>	n/a
Dyfrig John <sup>4</sup>	27,385	–	–	–	–	27,385	n/a <sup>6</sup>	n/a
Nick Luff	400,000	–	–	–	–	400,000	n/a <sup>6</sup>	n/a
Deborah McWhinney <sup>3</sup>	250,000	–	–	–	–	250,000	n/a <sup>6</sup>	n/a
Nick Prettejohn <sup>5</sup>	69,280	–	–	–	–	69,280	n/a <sup>6</sup>	n/a
Stuart Sinclair	–	–	–	–	–	–	n/a <sup>6</sup>	n/a
Anthony Watson	576,357	–	–	–	–	576,357	n/a <sup>6</sup>	n/a
Sara Weller	340,000	–	–	–	–	340,000	n/a <sup>6</sup>	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 2016 closing price of 62.51 pence. Full face value of awards are £22,734,988 for António Horta-Osório, £12,242,610 for George Culmer and £9,381,538 for Juan Colombás.

3 Shareholdings held by António Horta-Osório and Deborah McWhinney are either wholly or partially in the form of ADRs.

4 Shares held as at date of retirement.

5 In addition, Nick Prettejohn held 400 6.475% preference shares at 1 January 2016 and 31 December 2016.

6



Edgar Filing: Lloyds Banking Group plc - Form 20-F

The changes in beneficial interests for António Horta-Osório (595 shares), George Culmer (519 shares) and Juan Colombás (519 shares) relate to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2016 and 24 February 2017. There have been no other changes up to 24 February 2017.

A summary of transactions undertaken in the year, including share plan awards vested plus open market purchases and sales made by Directors, is shown on pages 148/149.

As a result of the above shareholdings, the position for each Executive Director is as follows:

	2016 Shareholding requirement			Current shareholding			New shareholding requirement from 1 January 2017		Current shareholding (based on new requirement)	
	Base salary plus fixed share award (£000s)	% of base salary plus fixed share award	Number of shares <sup>1</sup>	% of base salary plus fixed share award <sup>1</sup>	Number of shares as at 31/12/16 <sup>2</sup>	Old requirement met	% of base salary	Number of shares <sup>1</sup>	% of base salary <sup>1</sup>	New requirement met
<b>Executive Directors</b>										
António Horta-Osório	2,025	200%	6,560,829	545%	17,891,894	Yes	350%	6,917,220	905%	Yes
George Culmer	1,253	150%	3,044,925	519%	10,545,483	Yes	250%	3,094,403	852%	Yes
Juan Colombás	1,236	150%	3,002,634	318%	6,361,547	Yes	250%	3,051,426	521%	Yes

<sup>1</sup> Number of shares required and current shareholding percentage of base salary plus fixed share award figures are calculated using the average share price for the period 1 January 2016 to 31 December 2016 (61.73 pence).

<sup>2</sup> 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.

## COMPENSATION

## BREAKDOWN OF SHARES INTERESTS AND INTERESTS IN SHARE OPTIONS (AUDITED)

	At 1 January 2016	Granted/ awarded	Dividends awarded	Vested / exercised	Lapsed	At 31 December 2016	Exercise price	Exercise periods		Notes
								From	To	
<b>António Horta-Osório</b>										
LTIP 2013-2015	7,425,441	–	130,641	6,993,280	432,161	–				1, 2, 3
LTIP 2014-2016	4,640,077	–	–	–	–	4,640,077				3
LTIP 2015-2017	4,579,006	–	–	–	–	4,579,006				3
LTIP 2016-2018		5,015,210	–	–	–	5,015,210				3, 4
Deferred bonus awarded in 2016		1,164,253	–	–	–	1,164,253				5
2013 Sharesave	22,156	–	–	22,156	–	–	40.62p			8
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	10
<b>George Culmer</b>										
LTIP 2013-2015	4,017,041	–	70,674	3,783,249	233,792	–				1, 2, 3
LTIP 2014-2016	2,510,205	–	–	–	–	2,510,205				3
LTIP 2015-2017	2,477,167	–	–	–	–	2,477,167				3
LTIP 2016-2018		2,767,409	–	–	–	2,767,409				3, 4
Deferred bonus awarded in 2016		632,856	–	–	–	632,856				5
2013 Sharesave	22,156	–	–	22,156	–	–	40.62p			9
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	10

<b>Juan Colombás</b>										
LTIP										
2013-2015	<b>3,576,283</b>	–	62,920	3,368,143	208,140	–				1, 2, 3
LTIP										
2014-2016	<b>2,234,780</b>	–	–	–	–	<b>2,234,780</b>				3
LTIP										
2015-2017	<b>2,442,762</b>	–	–	–	–	<b>2,442,762</b>				3
LTIP										
2016-2018		2,728,973	–	–	–	<b>2,728,973</b>				3, 4
Deferred bonus awarded in 2016		624,065	–	–	–	<b>624,065</b>				5
Share buy-out award (share options)	<b>235,499</b>	–	–	235,499	–	–				6, 7
Share buy-out award (share options)	<b>299,732</b>	–	–	299,732	–	–				6, 7
2014 Sharesave	<b>29,990</b>	–	–	–	29,990	–	60.02p			
2016 Sharesave		29,109	–	–	–	<b>29,109</b>	47.49p	01/01/2020	30/06/2020	10

1 The shares awarded in March 2013 vested on 7 March 2016. The closing market price of the Group's ordinary shares on that date was 72.75 pence. Shares vested are subject to a further two-year holding period.

2 2013 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 7 March 2016. The closing market price of the Group's ordinary shares on that date was 72.75 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 2016 were made over shares with a value of 300 per cent of reference salary for António Horta-Osório (5,015,210 shares with a face value of £3,660,000); 275 per cent for George Culmer (2,767,409 shares with a face value of £2,019,600); and 275 per cent for Juan Colombás (2,728,973 shares with a face value of £1,991,550). The share price used to calculate face value is the average price over the five days prior to grant (1 March to 7 March 2016), which was 72.978 pence. This was the average share price used to determine the number of shares awarded. Performance conditions for this award have been disclosed in last year's annual report on remuneration (page 91).

5 Bonus is deferred into shares. The face value of the share awards in respect of bonuses granted in March 2016 was £849,649 (1,164,253 shares) for António Horta-Osório; £461,846 (632,856 shares) for George Culmer; and £455,431 (624,065 shares) for Juan Colombás. The share price used to calculate the face value is the average price over the five days prior to grant (1 March to 7 March 2016), which was 72.978 pence.

6 Share buy-out award granted on 30 March 2011 for the loss of deferred share awards forfeited on leaving the Santander Group. Awards are consistent with those forfeited and have a nil option price.

- 7 Options exercised on 8 March 2016. The closing market price of the Group's ordinary shares on that date was 70.63 pence.
- 8 Options exercised on 6 June 2016. The closing market price of the Group's ordinary shares on that date was 69.64 pence.
- 9 Options exercised on 1 June 2016. The closing market price of the Group's ordinary shares on that date was 71.34 pence.
- 10 Sharesave options granted on 10 October 2016.

The aggregate amount of gains made by Directors on the exercise of share options was £391,270.

None of the other Directors at 31 December 2016 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

## COMPENSATION

## DIRECTORS' INTERESTS – SUMMARY OF AWARDS VESTED, PURCHASES AND SALES MADE BY DIRECTORS IN 2016 (UNAUDITED)

	<b>Holding at 1 January 2016 (or appointment date)</b>	<b>Transactions during the year</b>	<b>Number of shares<sup>1</sup></b>	<b>Notes</b>	<b>Holding at 31 December 2016</b>
<b>Executive Directors</b>					
António Horta-Osório <sup>2</sup>	11,761,072	08/03/2016	3,706,439	Vesting of 2013 LTIP	
		08/03/2016	69,239	Dividend equivalent shares paid on 2013 LTIP	
		16/03/2016	173,707	Fixed Share Award	
		18/03/2016	8,256	Salary for shares	
		18/04/2016	2,803	Salary for shares	
		16/05/2016	1,437,096	Release of 2012 Deferred Bonus	
		16/05/2016	2,873	Salary for shares	
		06/06/2016	22,156	2013 Sharesave	
		17/06/2016	2,920	Salary for shares	
		17/06/2016	184,317	Fixed Share Award	
		28/06/2016	100,000	Share purchase	
		18/07/2016	3,377	Salary for shares	
		17/08/2016	3,482	Salary for shares	
		19/09/2016	3,330	Salary for shares	
		19/09/2016	210,206	Fixed Share Award	
		18/10/2016	3,549	Salary for shares	
		16/11/2016	3,069	Salary for shares	
		14/12/2016	2,994	Salary for shares	
		14/12/2016	189,000	Fixed Share Award	
		Monthly	3,841	Share Incentive Plan purchase and matching shares	<b>17,893,726</b>
George Culmer	7,090,093	08/03/2016	295,534	Release of 2013 Deferred Bonus	
		08/03/2016	2,005,122	Vesting of 2013 LTIP	
		08/03/2016	37,457	Dividend equivalent shares paid on 2013 LTIP	
		16/03/2016	97,276	Fixed Share Award	
		19/05/2016	210,244	Dividend Reinvestment	
		02/06/2016	22,156	2013 Sharesave	
		17/06/2016	103,218	Fixed Share Award	
		30/06/2016	50,000	Share purchase	
		19/09/2016	295,534	Release of 2013 Deferred Bonus	
		19/09/2016	117,715	Fixed Share Award	
		28/09/2016	113,779	Dividend Reinvestment	

Edgar Filing: Lloyds Banking Group plc - Form 20-F

		14/12/2016	105,840	Fixed Share Award	
		Monthly	3,347	Share Incentive Plan purchase and matching shares	<b>10,547,315</b>
Juan Colombás	3,145,458	08/03/2016	44,355	Release of 2012 Deferred Bonus	
		08/03/2016	277,981	Release of 2013 Deferred Bonus	
		08/03/2016	1,785,116	Vesting of 2013 LTIP	
		08/03/2016	33,347	Dividend equivalent shares paid on 2013 LTIP	
		16/03/2016	282,898	Exercise of Share buy out	
		16/03/2016	95,924	Fixed Share Award	
		17/06/2016	101,784	Fixed Share Award	
		30/06/2016	50,000	Share purchase	
		19/09/2016	44,355	Release of 2012 Deferred Bonus	
		19/09/2016	277,981	Release of 2013 Deferred Bonus	
		19/09/2016	116,080	Fixed Share Award	
		14/12/2016	104,370	Fixed Share Award	
		Monthly	3,347	Share Incentive Plan purchase and matching shares	<b>6,362,996</b>

148

## COMPENSATION

	<b>Holding at 1 January 2016 (or appointment date)</b>	<b>Transactions during the year</b>	<b>Number of shares</b>	<b>Notes</b>	<b>Holding at 31 December 2016</b>
<b>Non-Executive Directors</b>					
Lord Blackwell	50,000	05/05/2016	50,000	Share purchase	<b>100,000</b>
Alan Dickinson	100,000	29/06/2016	100,000	Share purchase	<b>200,000</b>
Anita Frew	300,000	29/06/2016	150,000	Share purchase	<b>450,000</b>
Simon Henry	100,000	30/06/2016	100,000	Share purchase	<b>200,000</b>
Dyfrig John <sup>3</sup>	27,385	–	–	–	<b>27,385</b>
Nick Luff	300,000	29/06/2016	100,000	Share purchase	<b>400,000</b>
Deborah McWhinney <sup>4</sup>	200,000	29/06/2016	50,000	Share purchase	<b>250,000</b>
Nick Prettejohn	–	26/02/2016	69,280	Share purchase	<b>69,280</b>
Stuart Sinclair	–	–	–	–	–
Anthony Watson	476,357	29/06/2016	100,000	Share purchase	<b>576,357</b>
Sara Weller	200,000	04/05/2016	100,000	Share purchase	
		29/06/2016	40,000	Share purchase	<b>340,000</b>

1 After the settlement of tax and National Insurance contributions, where applicable.

2 Part of António Horta-Osório's 2016 salary increase was delivered in shares.

3 Shares held as at date of retirement.

4 Held in the form of ADRs.

## ADDITIONAL DISCLOSURES

TOTAL REMUNERATION OF THE EIGHT HIGHEST PAID SENIOR EXECUTIVES<sup>1</sup>

The following table sets out the total remuneration of the eight highest paid senior executives (excluding Executive Directors) in respect of the 2016 performance year.

	Executive							
	<b>8</b>	<b>7</b>	<b>6</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
<b>Fixed</b>								
Cash-based	305	589	300	740	799	315	330	420
Share-based	200	406	250	490	500	500	740	650

Edgar Filing: Lloyds Banking Group plc - Form 20-F

<b>Total fixed</b>	505	995	550	1,230	1,299	815	1,070	1,070
<b>Variable</b>								
Upfront cash	2	2	2	2	2	2	2	2
Deferred cash	0	0	0	0	0	0	0	0
Upfront shares	273	152	416	187	217	462	658	238
Deferred shares	213	231	432	284	328	196	165	360
Long-term incentive plan <sup>2</sup>	1,042	744	884	833	780	2,020	2,571	2,886
Total variable pay	1,530	1,129	1,734	1,306	1,327	2,680	3,396	3,486
Pension cost <sup>3</sup>	46	147	45	181	182	63	66	84
<b>Total remuneration</b>	<b>2,081</b>	<b>2,271</b>	<b>2,329</b>	<b>2,717</b>	<b>2,808</b>	<b>3,558</b>	<b>4,532</b>	<b>4,640</b>

<sup>1</sup> Includes members of the Group Executive Committee and Senior Executive level colleagues.

<sup>2</sup> Values shown reflect awards for which the performance period ended on 31 December 2016, including the 2014 LTIP and 2014 Commercial Banking Transformation Plan. Dividend equivalents are included where applicable.

<sup>3</sup> Pension costs based on a percentage of salary according to level.

TOTAL REMUNERATION OF EMPLOYEES ACROSS THE GROUP

<b>Total remuneration<sup>1</sup></b>	<b>Number of employees</b>
£0 to £100,000	<b>73,415</b>
£100,001 to £500,000	<b>4,432</b>
£500,001 to £1,000,000	<b>145</b>
Above £1,000,000	<b>58</b>

Total remuneration of UK-based colleagues. Includes base salary, bonus awards for the 2016 performance year, the estimated values of LTIP and Commercial Banking Transformation Plan awards for the performance period ended 31 December 2016 (including dividend equivalents where applicable), pension and benefits.



## COMPENSATION

**REMUNERATION COMMITTEE**

## COMMITTEE PURPOSE AND RESPONSIBILITIES

The Remuneration Committee has responsibility for setting remuneration for all Executive Directors and the Chairman, including pension rights and any compensation payments. The Committee also recommends and monitors the level and structure of remuneration for senior management and material risk takers.

The Committee's purpose is to consider, agree and recommend 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. The Committee's Terms of Reference can be found on the Company's website at [www.lloydsbankinggroup.com/our-group/corporate-governance](http://www.lloydsbankinggroup.com/our-group/corporate-governance)

The Directors who served on the Committee during the year and their attendance at Committee meetings is set out in the table below.

	<b>Remuneration Committee meetings Eligible to attend    Attended</b>	
<b>Committee Chairman</b>		
Anita Frew	7	7
<b>Committee members who served during 2016</b>		
Lord Blackwell	7	7
Alan Dickinson	7	7
Stuart Sinclair <sup>1</sup>	7	7
Anthony Watson <sup>2</sup>	7	6
Sara Weller	7	7
<b>Former members who served during 2016</b>		
Dyfrig John <sup>3</sup>	3	3

<sup>1</sup> Joined the Committee on 4 January 2016.

2 Anthony Watson was unable to attend the Committee meeting in May 2016 due to a prior commitment.

3 Retired on 11 May 2016.

## COMMITTEE COMPOSITION, SKILLS AND EXPERIENCE

The Committee comprises Non-Executive Directors from a wide background to provide a balanced and independent view on remuneration matters. Stuart Sinclair was appointed as an independent Non-Executive Director and as a member of the Committee on 4 January 2016. Dyfrig John retired as an independent Non-Executive Director and as a member of the Committee on 11 May 2016.

## HOW COMMITTEE MEETINGS ARE RUN

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 155, with a structure which facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committee to consider proposals which are put forward.

During 2016, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

## MATTERS CONSIDERED BY THE COMMITTEE

The Committee had seven scheduled meetings during 2016 to consider the following principal matters:

- Review of remuneration arrangements for senior executives;
- Determination of 2015 bonus outcome based on divisional and functional performance and adjustment for risk;
- Review of the Balanced Scorecard for the determination of 2016 bonuses in divisions and functions;
- Vesting of the 2013 long-term incentive plan (LTIP);

-Performance conditions for the 2016 LTIP;

-Bonus and salary awards for Executive Directors and key senior managers;

-Performance adjustments in respect of staff, in relation to risk matters in its purview;

-Feedback from the Committee Chairman on her meetings with the PRA and shareholders;

-Review of services and consideration of a number of advisors with subsequent appointment of Kepler, a brand of Mercer (Kepler);

-Results of the Remuneration Committee effectiveness review and the suggestions for improvement;

-Variable remuneration and simplification of reward principles;

-Approval of the 2015 and 2016 Directors' remuneration report for publication within the annual report and Form 20-F;

-Review and approval of material risk taker identification and approval of the Remuneration Policy Statement; and

-Remuneration governance in the light of regulatory changes.

In addition to the scheduled meetings, the Committee met on a number of other occasions to allow the Directors greater time to discuss their views and for an in-depth review of key areas including this year the review of the Directors' Remuneration Policy.

## COMPENSATION

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. In May 2016, the Committee conducted a review of their independent advisers and appointed Kepler to advise the Committee following a competitive tendering process. Kepler has voluntarily signed up to the Remuneration Consultants' Code of Conduct and is judged by the Committee to be independent. Kepler is not connected with the Group. Kepler's fees for services to the Committee in 2016 were on a time and materials basis and amounted to £175,400. Kepler did not provide any other services to the Group. Mercer provides unrelated advice regarding pensions and investments to the Group.

The Committee has not formally evaluated Kepler's performance since their appointment in mid-2016. A review is due to be undertaken in early 2017. Deloitte LLP, independent consultants to the Committee since 2010, provided advice for the first five months of the year. Deloitte LLP is not connected with the Group. Deloitte's fees for services to the Committee in 2016 were on a time and materials basis and amounted to £240,800. In addition, Deloitte LLP provided the Group with advice on taxation and other consulting services, and assurance services.

António Horta-Osório (Group Chief Executive), Simon Davies (Chief People, Legal and Strategy Officer), Paul Hucknall (People Director, Centres of Excellence), Chris Evans (Director, Reward Policy and Partnering), Stuart Woodward (Head of Reward Regulation and Governance) and Matthew Elderfield (Group Director, Conduct, Compliance and Operational Risk) (until September 2016) and Letitia Smith thereafter provided guidance to the Committee (other than for their own remuneration).

Juan Colombás (Chief Risk Officer) and George Culmer (Chief Financial Officer) also attended the Committee to advise as and when necessary on risk and financial matters.

## STATEMENT OF VOTING AT ANNUAL GENERAL MEETING

The Group's remuneration policy, which was effective during 2016, was detailed within the Directors' remuneration report for 2013 and voted on at the 2014 AGM. The remuneration awarded to the Executive Directors in 2015 was disclosed in last year's annual report on remuneration and was voted on at the 2016 AGM. The shareholder votes submitted at the meetings, either directly, by mail or by proxy, were as follows:

<b>Votes cast in favour</b>		<b>Votes cast against</b>		<b>Votes withheld</b>
Number of shares (millions)	Percentage of votes cast	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)

Edgar Filing: Lloyds Banking Group plc - Form 20-F

Remuneration policy (2014 vote)	<b>48,261</b>	<b>97.97%</b>	<b>999</b>	<b>2.03%</b>	<b>1,391</b>
Annual report on remuneration (2016 vote)	<b>48,674</b>	<b>97.67%</b>	<b>1,163</b>	<b>2.33%</b>	<b>176</b>

151

CORPORATE GOVERNANCE

**STATEMENT ON US CORPORATE GOVERNANCE STANDARDS**

The Board is committed to the delivery of the Group's strategy to become the best bank for customers, whilst delivering long-term, superior and sustainable returns to shareholders. 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 2014 UK Corporate Governance Code (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](http://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](http://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 164 to 175.

Further information about the work of the Remuneration Committee is included on pages 150 and 151.

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 2016 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

This report sets out our approach to governance in practice, the work of the Board and its committees and explains how the Group applied the principles of the UK Corporate Governance Code (the Code) during 2016

### **LEADERSHIP**

### **THE BOARD**

The Group is led by an effective, committed and unitary Board, which is collectively responsible for the long-term success of the Company. The Board comprises a Chairman (who was independent on appointment), independent Non-Executive Directors and Executive Directors. The names and biographies of current Directors are set out on pages 117 to 120.

There is a clear division of responsibility at the head of the Company, which is documented in the Group's Corporate Governance Framework. The Chairman has overall responsibility for the leadership of the Board and for ensuring its effectiveness while the Group Chief Executive manages and leads the business.

The Corporate Governance Framework, which is reviewed annually by the Board, sets out a number of key decisions and matters that are reserved for the Board's approval.

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.

### **KEY ROLES AND RESPONSIBILITIES**

**Chairman**  
**Lord Blackwell**



Lord Blackwell leads the Board and promotes the highest standards of corporate governance. He sets the Board's agenda and builds an effective and complementary Board. The Chairman leads Board succession planning and ensures effective communication with shareholders.

### **Deputy Chairman**

#### **Anita Frew**

Anita Frew as Deputy Chairman ensures continuity of Chairmanship during any change of chairmanship. She supports the Chairman in representing the Board and acting as a spokesperson. She deputises for the Chairman and is available to the Board for consultation and advice. The Deputy Chairman represents the Group's interests to official enquiries and review bodies.

### **Senior Independent Director**

#### **Anthony Watson**

As the Senior Independent Director, Anthony Watson is a sounding board for the Chairman and Group Chief Executive. He acts as a conduit for the views of other Non-Executive Directors and conducts the Chairman's annual performance appraisal. He is available to help resolve shareholders' concerns and attend meetings with major shareholders and financial analysts to understand issues and concerns.

### **Non-Executive Directors**

#### **Alan Dickinson, Simon Henry, Nick Luff, Deborah McWhinney, Nick Prettejohn, Stuart Sinclair, Sara Weller**

The Non-Executive Directors challenge constructively and help develop and set the Group's strategy. They actively participate in Board decision making and scrutinise management performance. The Non-Executive Directors satisfy themselves on the integrity of financial information and review the Group's risk exposures and controls.

The Non-Executive Directors, through the Remuneration Committee, determine the remuneration of Executive Directors.

### **Group Chief Executive**

#### **António Horta-Osório**

António Horta-Osório manages the Group on a day-to-day basis and makes decisions on matters affecting the operation, performance and strategy of the Group's business. He delegates aspects of his own authority, as permitted under the Corporate Governance Framework, to members of the Group Executive Committee (GEC). He provides leadership and direction to senior management and coordinates all activities to implement the strategy and for managing the business in accordance with the Group's risk appetite and business plan set by the Board.

### **Executive Directors**

#### **Juan Colombás, George Culmer**

Under the leadership of the Group Chief Executive, the Executive Directors make and implement decisions in all matters affecting operations, performance and strategy. They provide specialist knowledge and experience to the Board. They are responsible for the successful leadership and management of the Risk and Finance divisions respectively. The Executive Directors design, develop and implement strategic plans and deal with day-to-day operations of the Group.

**Company Secretary**

**Malcolm Wood**

The Company Secretary advises the Board and ensures good information flows and comprehensive practical support are provided to Directors. He maintains the Group's Corporate Governance Framework and organises Directors' induction and training. The Company Secretary communicates with shareholders as appropriate and ensures due regard is paid to their interests. Both the appointment and removal of the Company Secretary is a matter for the Board as a whole.

153

## CORPORATE GOVERNANCE

### **BOARD AND GOVERNANCE STRUCTURE**

#### **LLOYDS BANKING GROUP BOARD**

A full schedule of all matters reserved to the Board and Terms of Reference for each of the Board Committees can be found at [www.lloydsbankinggroup.com/our-group/corporate-governance](http://www.lloydsbankinggroup.com/our-group/corporate-governance)

#### **BOARD COMMITTEES**

The Board is supported by its Committees which make recommendations on matters delegated to them under the Corporate Governance Framework, in particular in relation to internal control, risk, financial reporting, governance and remuneration matters.

This enables the Board to spend a greater proportion of its time on strategic, forward looking agenda items. Each Committee comprises Non-Executive Directors only and is chaired by an experienced Chairman. The Committee Chairmen report to the Board on the activities of the Committee at each Board meeting.

The Board recognises that governance must be dynamic and evolve to meet current and future demands. Therefore, in 2016 two further sub-committees of the Board Risk Committee were established to focus on Financial Markets and IT Resilience & Cyber, in addition to an existing Stress Testing & Recovery Planning sub-committee. The sub-committees were constituted to enable members of the Board Risk Committee to dedicate additional time and resource to better understand and to enable fuller review and challenge of the risks associated with the topic of the sub-committee. Current direct Board level oversight of these activities through regular updates and annual review continues unchanged.

Additionally, a Cyber Security Advisory Panel was established to bring an industry perspective and allow for discussion of the key cyber related activities and threats.

#### **THE BOARD IN 2016**

Non-Executive Directors see attendance at Board and Committee meetings as only one part of their role. In addition to the annual schedule of Board and Committee meetings, the Non-Executive Directors undertake a full programme of activities each year, as set out on page 158 .

Non-Executive Directors regularly meet with senior management and spend time increasing their understanding of the business through site visits, formal briefing sessions or more informal events including breakfast meetings with senior staff, which the Chief People, Legal and Strategy Officer also attends. Board dinners are held prior to each scheduled Board meeting. This allows the Directors greater time to discuss their views, ensuring that there is sufficient time for the Board to discuss matters of a material nature at Board meetings. Some of these pre meetings are for Non-Executive Directors only, some also include the Group Chief Executive and others the full Board and GEC members. At least once a year, a meeting is held without the Chairman in attendance.

Prior to the annual general meeting (AGM) in Scotland the Board held a joint discussion with the Board of Scottish Widows Group Limited allowing in-depth focus on insurance matters.

The Board has agreed the following changes to our Board composition since the year end. Anthony Watson, Senior Independent Director, will retire at the 2017 AGM after serving more than eight years on the Board. Anita Frew will succeed Anthony as Senior Independent Director. Anita will combine the role of Senior Independent Director with the role of Deputy Chairman, which she has held since May 2014. Anita's significant board, financial and investment management experience, including as a Senior Independent Director, make her ideally suited to take on this role. Nick Luff, an independent Non-Executive Director, has notified the Board that in light of his other commitments he does not intend to seek re-election at the 2017 AGM. Nick will be succeeded as Chairman of the Audit Committee by Simon Henry. Simon has significant financial experience in the UK listed environment, retiring as Chief Financial Officer of Royal Dutch Shell plc in March 2017. His background and experience enable him to fulfil the role of Audit Committee Chairman and for SEC purposes the role of Audit Committee financial expert.

## CORPORATE GOVERNANCE

## ATTENDANCE AT BOARD MEETINGS IN 2016

	<b>Eligible to attend</b> <sup>1</sup>	Attended
<b>Directors who served during 2016</b>		
António Horta-Osório	9	9
Lord Blackwell	9	9
Juan Colombás	9	9
George Culmer	9	9
Alan Dickinson	9	9
Anita Frew	9	9
Simon Henry <sup>2</sup>	9	8
Nick Luff	9	9
Deborah McWhinney	9	9
Nick Prettejohn <sup>3</sup>	9	8
Stuart Sinclair <sup>4</sup>	9	9
Anthony Watson	9	9
Sara Weller	9	9
<b>Former directors who served during 2016</b>		
Dyfrig John <sup>5</sup>	4	4

<sup>1</sup> The attendance of Directors at Committee meetings is displayed within the individual Committee reports found on pages 164 to 175 and for the Remuneration Committee on page 150. Whilst all Non-Executive Directors are, where appropriate, invited to and regularly attend other Committee meetings, only their attendance at Committees of which they are members is recorded.

<sup>2</sup> Mr Henry was unable to join the July Board meeting due to the second quarter 2016 results announcement for Royal Dutch Shell plc, of which he is Chief Financial Officer, being presented on the same day.

<sup>3</sup> Mr Prettejohn was unable to join the June Board meeting due to a prior commitment.

<sup>4</sup> Joined the Board on 4 January 2016.

<sup>5</sup> Retired on 11 May 2016.

## HOW BOARD MEETINGS ARE RUN

The Chairman ensures Board meetings are structured to facilitate open discussion, debate and challenge. Through his opening remarks, the Chairman sets the focus of each meeting.

In the rare event of a Director being unable to attend a meeting, the Chairman discusses the matters proposed with the Director concerned, seeking their support and or feedback accordingly. The Chairman subsequently represents those views at the meeting.

Directors are sent papers for the Board meeting typically seven days in advance of the meeting in order that they may have the time to consider the proposals put forward and seek clarification or further information as required. The Board makes full use of technology such as video conferencing, teleconferencing, a Board portal and tablets in its meeting arrangements. This leads to greater flexibility, security and efficiency in Board paper distribution.

#### ENSURING THE RIGHT FOCUS TO DELIVER THE GROUP'S STRATEGY

The Board recognises the need to be adaptable and flexible to respond to changing circumstances and emerging business priorities, whilst ensuring the continuing monitoring and oversight of core issues.

The Group has a comprehensive and continuous agenda setting and escalation process in place for ensuring the Board has the right information at the right time and in the right format to enable the Directors to make the right decisions. The Chairman leads the process, assisted by the Group Chief Executive and Company Secretary. The process ensures that sufficient time is being set aside for strategic discussions and business critical items.

The process of escalating issues and agenda setting is reviewed at least annually as part of the Board Effectiveness Review with enhancements made to the process, where necessary, to ensure it remains effective.

The Non-Executive Directors also receive regular updates from the Group Chief Executive's office including a weekly email which gives context to current issues. In-depth and background materials are regularly provided via a reading room on the Board portal.

#### SENIOR MANAGERS AND CERTIFICATION REGIME

Last year, the Corporate Governance Framework was reviewed in preparation for the introduction in March 2016 of the Senior Managers and Certification Regime (SM&CR) and, as relevant to the Scottish Widows Group, the Senior Insurance Managers Regime.

The review, which was part of a wider range of initiatives undertaken to prepare the Group for the introduction of SM&CR, found that the framework was generally aligned with the requirements of the SM&CR but a number of changes were recommended.

These included amendments to the statements of responsibilities of the Directors and members of the GEC and minor amendments to the terms of reference of a number of Board and Group Chief Executive Committees.

155

CORPORATE GOVERNANCE

**AGENDA SETTING PROCESS**

**PROCESS FOR ESCALATING ISSUES**

Board and Committee agendas and topics

156



CORPORATE GOVERNANCE

**BOARD FOCUS IN 2016**

**Financial**

- Budget for 2016
- Group operating plan
- Draft results and presentation to analysts
- Approval of dividends
- Funding and Liquidity plan
- Capital plan

**Strategy**

- Review of progress in implementing the Group’s 2015-17 strategy
- Approval of large transactions
- MBNA acquisition
- EU referendum outcome
- Review of future environment and business model

**Culture and values**

- Customer performance dashboard
- Conduct, culture and values
- Responsible Business report
- Helping Britain Prosper Plan

**Governance and shareholders**

- Board effectiveness and Chairman’s performance reviews
- Board Diversity Policy
- Review of Corporate Governance Framework
- Investor Relations updates
- AGM briefing
- In the first half of 2016, preparation for proposed public offering of shares in the Company by HM Treasury

**Regulatory**

- Ring-fencing and resolution
- SM&CR updates
- Regulatory updates
- Whistleblowing updates

**Risk management**

- Approval of Group risk appetite
- Approval of Risk Management Framework
- Review of internal control systems
- Review and approval of PRA and EBA stress testing results
- CMA market review into retail banking services
- IT resilience and cyber security

**BOARD MEETINGS AND ACTIVITY IN 2016**



CORPORATE GOVERNANCE

**BOARD ACTIVITIES IN 2016 – SUPPORTING DELIVERY OF THE GROUP'S STRATEGIC PRIORITIES**

**Deep dives**

The Board regularly takes the opportunity to hold 'deep dive' sessions with senior management outside of formal Board meetings.

The purpose of the sessions is to provide the Board with deeper insight into key areas of strategic focus. The sessions are structured to allow for plenty of opportunity for discussion and include presentations and videos.

In 2016 'deep dive' sessions were held on the following topics:

– Commercial Banking

– Customer perspective

– Data infrastructure and information security

**Board strategy offsite**

The Board sets aside time each year outside of the annual Board calendar to hold a strategy offsite giving the Directors the opportunity to solely focus on strategic issues.

This year the Board and the GEC held a two day offsite in June to discuss the strategic challenges and opportunities the Group faces in the future, based on four scenarios for how banking could evolve over the next ten years. The offsite enabled the Board to take a view of the longer-term outlook for the Group. The Board debated the transformation required to be 'Bank of the Future' in order to underpin continued competitive success. This will provide the backdrop to the next phase of strategic development, on which the Group will report later in 2017.

The agenda included case studies from banking and other industries, and presentations from senior management and smaller break-out sessions on specific topics.

– Consumer Finance

The offsite concluded with a group discussion leveraging the broad range of experience and perspectives from across the Board.

– Customer segmentation

– Retail product pricing

**Creating the best customer experience**      **Becoming simpler and more efficient**      **Delivering sustainable growth**

#### **Board visit to Halifax**

#### **Chairman's engagement programme**

Over two days in November the Board visited the Group's Halifax offices. In addition to the Board and Committee meetings, a separate strategy meeting, attended by GEC members, was held reviewing the Group operating plan. During the visit, the Chairman and several Non-Executive Directors, spent half a day with some of the c3,000 colleagues based in Halifax. The visit included a walk through the Mortgage Transformation lab to learn about the improvements being made to the customer mortgage journey.

The Chairman undertakes an extensive engagement programme each year representing the Group at industry events, acting as a spokesperson for the Group and meeting with clients, regulators, investors, the media, the Foundations and their beneficiaries.

The programme includes visits to regional offices, branches, IT and operations centres, where the Chairman meets local management and colleagues through meetings, floor walks, team talks and Town Hall sessions. The Town Hall sessions are an opportunity for colleagues to hear from the Chairman on the Group's performance and strategic direction, and importantly, to ask questions. These events are very popular and are always well attended.

The Chairman and Non-Executive Directors also spent time with the

Banking Complaints Team, where they followed a complaint through to its outcome and joined a 'huddle' discussing how Financial Ombudsmen Service learnings could be used to ensure fair customer outcomes in the future.

## **SHOWING SUPPORT FOR CUSTOMERS AND THE COMMUNITY**

In September, Lord Blackwell spent two days in Aberdeen where he met with more than 100 business customers. During his visit, he delivered the keynote speech at a dinner for customers and local influencers, emphasising the Group's vital role in helping Britain prosper and the importance of building long-term customer relationships. At a breakfast for Mid Markets clients and local business leaders, he outlined his views on the economy and the importance of supporting local businesses.

Lord Blackwell also found time to host a Town Hall and Q&A session for colleagues at the Group's Albyn Place office. His final stop was an inspiring visit to Fly Cup Catering in Inverurie, a charity funded by the Bank of Scotland Foundation which provides catering training, employment experience and placements for adults with learning difficulties.

Speaking about the visit, he said: 'I came away enthused by the commitment and enthusiasm of everyone I met, and by the general sense of cautious optimism from our commercial clients and relationship managers. It is extremely helpful to me to hear these perspectives first hand and to meet more of our tremendous colleagues.'

## CORPORATE GOVERNANCE

### **EFFECTIVENESS**

### **BOARD INDUCTION**

The Chairman personally ensures that on appointment each Director receives a full, formal and tailored induction. The emphasis is on ensuring the induction brings the business and its issues alive for the new Director, taking account of the specific role they have been appointed to fulfil and the skills/experience of the Director to date.

Directors who take on or change roles during the year attend induction meetings in respect of those new roles.

An outline of the induction programme is set out on page 160 and Deborah McWhinney and Stuart Sinclair share their experiences on joining the Board on page 166.

### **PROFESSIONAL DEVELOPMENT AND TRAINING**

The Chairman leads the learning and development of Directors and the Board generally and regularly reviews and agrees with each Director their training and development needs.

Ample opportunities, support and resources for learning are provided through a comprehensive programme, which is in place throughout the year comprising both formal and informal training and information sessions.

The Company Secretary maintains a training and development log for each Director.

### **TIME COMMITMENTS**

Non-Executive Directors are required to devote such time as is necessary for the effective discharge of their duties. The estimated minimum time commitment set out in the terms of appointment is 35-40 days per annum including

attendance at Committee meetings. For Committee Chairmen and the Senior Independent Director, this increases to a minimum of 45 to 50 days. As described elsewhere, the time devoted on the Group's business by the Non-Executive Directors is in reality considerably more than the minimum requirements.

Executive Directors are restricted to taking no more than one non-executive director role in a FTSE 100 company and may not take on the chairmanship of such a company. The Chairman is committed to this being his primary role, limiting his other commitments to ensure he can spend as much time as the role requires. In February 2016, the Chairman retired as Chairman of Interserve plc. The Chairman's biography can be found on page 117.

## **CONFLICTS OF INTEREST**

The Board has a comprehensive procedure for reviewing and, as permitted by the Companies Act 2016 and the Company's articles of association, approving actual and potential conflicts of interests.

Directors have a continuing duty to notify the Chairman and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to the commitments of all Directors are reported to the Nomination and Governance Committee and the Board and a register of potential conflicts and time commitments is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

If any potential conflict arises, the articles of association permit the Board to authorise the conflict, subject to such conditions or limitations as the Board may determine. Decisions regarding these conflicts of interest could be and are only taken by Directors who have no interest in the matter. In taking the decision, the Directors act in a way they consider, in good faith, would be most likely to promote the Company's success. Any authorities given are reviewed periodically, and as considered appropriate, and at least every 15 months. No Director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest. The Board confirms that no material conflicts were reported to it during the year.

Stuart Sinclair is Senior Independent Director at both QBE Insurance (Europe) Limited, a general insurance and reinsurance company, and Swinton Group Limited, an insurance broker for home and motor insurance. The Board has recognised that potential conflicts may arise in relation to his position at QBE Insurance and in relation to Swinton Group. The Board has authorised the potential conflicts and requires Mr Sinclair to recuse himself from discussions, should the need arise.

## **ACCESS TO ADVICE**

The Group provides access, at its expense, to the services of independent professional advisers in order to assist Directors in their role. Board Committees are also provided with sufficient resources to undertake their duties. All Directors, including Non-Executive Directors, have access to the services of the Company Secretary in relation to the discharge of their duties.



CORPORATE GOVERNANCE

**BOARD INDUCTION PROGRAMME**

- Core programme
  - Strategic and corporate induction
  - Governance and Director responsibilities
  - Senior Managers and Certification Regime
  - Detailed risk induction programme
  - Detailed briefings on each of the Group’s business divisions
  - Branch and site visits
  - Opportunity to meet with major shareholders as requested
  - Chairman
  - Company Secretary
- One-to-one briefings – Executive Directors
  - GEC members
  - Group Audit Director
  - Senior executives from across the Group
- Bespoke programme – The Chairman personally ensures a new Director receives a tailored induction.
  - Specific briefings are provided on the Committees on which the new Director will serve.

**Briefing and reading materials**

Briefing and reading materials are made available on the Board portal.

**PROFESSIONAL DEVELOPMENT AND TRAINING PROGRAMME AT A GLANCE**

## **BOARD EFFECTIVENESS**

The Chairman of the Board leads the annual review of the Board's effectiveness and that of its Committees and individual Directors with the support of the Nomination and Governance Committee, which he also chairs. The annual evaluation is facilitated externally at least once every three years.

### **2016 EVALUATION OF THE BOARD'S PERFORMANCE**

The 2016 evaluation was conducted internally between November 2016 and December 2016 by the Company Secretary, and was overseen by the Nomination and Governance Committee.

The 2016 review sought the Directors' views on a range of topics including: strategy; planning and performance; risk and control; Board composition and size; balance of skills and experience; diversity; culture and dynamics; the Board's calendar and agenda; the quality and timeliness of information; and support for Directors and Committees.

If Directors have concerns about the Company or a proposed action which cannot be resolved, it is recorded in the Board minutes. Also on resignation, Non-Executive Directors are encouraged to provide a written statement of any concerns to the Chairman, for circulation to the Board. No such concerns were raised in 2016 and up to the date of the annual report.

Anthony Watson, Senior Independent Director, is due to retire at the 2017 AGM. At the time of the 2017 AGM, he will have served on the Board for more than eight years and therefore, in compliance with the Code, his review was particularly rigorous.

### **OUTCOME OF 2016 BOARD EFFECTIVENESS REVIEW**

The reviews concluded that the performance of the Board, its Committees, the Chairman and each of the Directors continues to be effective. All Directors demonstrated commitment to their roles.

Many Directors commented favourably on the performance of the Board as a whole, describing it as hardworking, collegiate, questioning and highly engaged. Developments during 2016, including the continued use of deep dives, the establishment of sub-committees of the Board Risk Committee and the Cyber Security Advisory Panel have generally been welcomed and Directors have commented on the high quality of debate within the Board. Highlights mentioned by several Directors were the strategy offsite in June and governance of the acquisition of the MBNA UK consumer credit card business, where the Board was highly engaged in oversight and challenge of the acquisition process. Directors also spoke highly of the work done by the Chairman and the Chairs of the Committees in structuring agendas and ensuring that business is covered at the meetings.

#### RECOMMENDATIONS FROM THE 2016 BOARD EFFECTIVENESS REVIEW (INTERNAL)

The review identified a number of actions to maintain and improve the Board's effectiveness.

#### **Volume of Board/Committee papers**

The most common observation by Directors concerned the volume of information which they received. Directors would like to receive more concise reports with clearer signposting of the key issues.

corporate governance

### **Links to strategy**

Several Directors said they would welcome more frequent linkage to strategy in the regular business of the Board.

### **Conduct of Board/Committees**

Several Directors said that they would value more time in agendas for discussion, while recognising the pressures on meeting time.

### **2016 EVALUATION PROCESS**

Step 1 Detailed questionnaire completed by each Director

Step 2 Individual meetings held between each Director and the Company Secretary

Step 3 Evaluation of the findings by the Company Secretary and report prepared

Step 4 Draft conclusions discussed by the Company Secretary with the Chairman

Step 5 Discussion of the Company Secretary's report and draft conclusions and actions agreed

#### **Chairman's evaluation**

The Senior Independent Director carried out the evaluation of the Chairman's performance using a questionnaire and individual meetings with Directors other than the Chairman. The outcome of the evaluation of the Chairman's performance was discussed by the Directors in the absence of the Chairman.

### **2015 BOARD EFFECTIVENESS REVIEW (EXTERNAL)**

In accordance with the three year cycle, the 2015 evaluation was facilitated externally by JCA Group between October 2015 and January 2016. The review was commissioned by the Chairman, assisted by the Company Secretary and overseen by the Nomination and Governance Committee. A summary of the Board's progress against the actions arising from the 2015 effectiveness review are set out below.

#### **Recommendations**

##### *STRATEGY*

– Continue to focus on strategy, with particular attention to the longer term horizon and the impact of the changing technology and competitive landscape

##### *SUCCESSION PLANNING*

#### **Actions taken/progress**

– 2016 strategy offsite focused on reviewing future environment and business model

– Regular Board deep dives and discussion topics related to digital disruption and strategic development held during the year

- Maintain a proactive approach to succession planning for Executive and Non-Executive Directors and for senior management
- Non-Executive Director discussion on Executive succession carried out
- Non-Executive Directors are informed about and able to input on Group Chief Executive succession planning
- Chairman and Nomination and Governance Committee continued to review Non-Executive Director profile and succession

#### *BOARD INFORMATION*

- Continue the progress made in 2015 in ensuring that information provided to the Board and its Committees is clear, concise, relevant and focused
- Continued progress on reducing unnecessary material and presentations
- Revised Board template and guidance in place
- Review and continue to evolve metrics used to assess business performance to ensure that they provide an appropriate level of detail and insight for the Board
- Regular reporting on business performance has continued to develop in response to Board feedback

#### **INTERNAL CONTROL**

#### **BOARD RESPONSIBILITY**

The Board is responsible for the Group's risk management and internal control systems, which are designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. The Directors and senior management are committed to maintaining a robust control framework as the foundation for the delivery of effective risk management. The Directors acknowledge their responsibilities in relation to the Group's risk management and internal control systems and for reviewing their effectiveness.

In establishing and reviewing the risk management and internal control systems, the Directors carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency or liquidity, the likelihood of a risk event occurring and the costs of control. The process for identification, evaluation and management of the principal risks faced by the Group is integrated into the Group's overall framework for risk governance. The Group is forward-looking in its risk identification processes to ensure emerging risks are identified. The risk identification, evaluation and management process also identifies whether the controls in place result in an acceptable level of risk. At Group level, a consolidated risk report and risk appetite dashboard are reviewed and regularly debated by the Group Risk Committee, Board Risk Committee and the Board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The report and dashboard provide a monthly view of the Group's overall risk profile, key risks and management actions, together with performance against risk appetite and an assessment of emerging risks which could affect the Group's performance over the life of the operating plan. Information regarding the main features of the internal control and risk management systems in relation to the financial reporting process is provided within the risk management report on pages 38 to 59. The Board concluded that the Group's risk management arrangements are adequate to provide assurance that the risk management systems put in place are suitable with regard to the Group's profile and strategy.

corporate governance

## **CONTROL EFFECTIVENESS REVIEW**

An annual control effectiveness review (CER) is undertaken to evaluate the effectiveness of the Group's control framework with regard to its material risks, and to ensure management actions are in place to address key gaps or weaknesses in the control framework. Business areas and head office functions assess the controls in place to address all material risk exposures across all risk types. The CER considers all material controls, including financial, operational and compliance controls. Senior management complete an attestation to confirm the CER findings which are reviewed and independently challenged by the Risk Division and Group Audit and reported to the Board. Action plans are implemented to address any control deficiencies.

## **REVIEWS BY THE BOARD**

The effectiveness of the risk management and internal control systems is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken by the Risk Division and Group Audit. The Audit Committee receives reports from the Company's auditor, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditor at least once a year without executives present, to ensure that there are no unresolved issues of concern.

The Group's risk management and internal control systems are regularly reviewed by the Board and are consistent with the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting issued by the Financial Reporting Council and compliant with the requirements of CRD IV. They have been in place for the year under review and up to the date of the approval of the annual report. The Group has determined a pathway to compliance with BCBS 239 risk data aggregation and risk reporting requirements and continues to actively manage enhancements.

## **CONCLUSION**

Our Controls Frameworks are continuously improved and enhanced, addressing known issues and keeping pace with the dynamic environment. Progress continues to be made in IT, Cyber, and Financial Crime. The 2016 CER assessment provides reasonable assurance that the Group's controls are effective or that where control weaknesses are identified, they are subject to management oversight and action plans. The Audit Committee, in conjunction with the Board Risk Committee, concluded that the assessment process was effective and recommended them to the Board for approval.

## REMUNERATION

The statement by the Chairman of the Remuneration Committee, the Directors' Remuneration policy and the Directors' Remuneration Implementation Report are set out on pages 120 to 151.

## SPOTLIGHT ON SUBSIDIARY GOVERNANCE

The Group conducts the majority of its business through a number of subsidiary entities. The Corporate Governance Framework sets out minimum governance standards and a subsidiary directors' handbook sets out detailed guidance on the role and responsibilities of a subsidiary director.

An annual certification process, at individual entity level, of compliance with the minimum governance standards set out in the Corporate Governance Framework enhances management of any legal, regulatory and reputational risks associated with the Group's subsidiary entities. The process provides GEC members with additional oversight of subsidiary entities within their respective

business area, including an escalation process for any matters of non-compliance. In addition, the process provides continued focus on simplification of the Group's legal entity structure through consideration of the lifecycle of each entity.

### **Scottish Widows Group Limited**

The Board of the Group's insurance subsidiary, Scottish Widows Group Limited, which also sits as the Board of its major subsidiaries, is chaired by a Non-Executive member of the Lloyds Banking Group Board and contains a balance of independent Non-Executive Directors, Group executives (serving as Non-Executives) and Insurance Division executives. This composition supports its legal and regulatory requirements for independent decision making within the overall framework of Group policies and controls.

## SHAREHOLDER RELATIONSHIPS

The Board recognises and values greatly the need to deliver a programme of engagement that offers all shareholders the opportunity to receive Company communications and to share their views with the Board.

The Group has a diverse range of shareholders and investors with different communication and engagement needs which are addressed by specialist teams.

The Group's website enables access to documents and communications as soon as they are published, including a live webcast of the AGM. Recordings of webcasts and other analyst presentations are also available.



## **RELATIONSHIPS WITH INSTITUTIONAL INVESTORS**

Investor Relations has primary responsibility for managing and developing the Group's external relationships with existing and potential institutional equity investors and analysts. With support from senior management, they achieved this through a combination of more than 1,100 meetings and various presentations in 2016. The presentations were primarily aligned to results and included content on strategic progress and financial and operational performance.

In addition to this direct shareholder engagement, Investor Relations provides regular reports to the executive team and Board on key market issues and shareholder concerns.

## **CORPORATE GOVERNANCE MEETING WITH INSTITUTIONAL SHAREHOLDERS**

In October 2016, the Chairman hosted a meeting with a number of large institutional shareholders focused on the Group's corporate governance arrangements. Following an overview from the Chairman on the Group's strategy and culture and Board governance, the shareholders heard from each of the Chairmen of the Audit, Board Risk, Remuneration and Responsible Business Committees and the Senior Independent Director. The meeting was also attended by the Company Secretary and the Group Investor Relations Director. The meeting was structured to allow for an open dialogue and discussion on the matters of importance to institutional shareholders. Those in attendance were especially interested in hearing about the Group's approach to becoming a more responsible business.

## CORPORATE GOVERNANCE

### GOVERNANCE AND EXECUTIVE REMUNERATION

Lord Blackwell (Chairman and Chairman of the Nomination and Governance Committee) and Anita Frew (Deputy Chairman and Chairman of the Remuneration Committee) participated in meetings and discussions with investors and other stakeholders, including the Group's regulators, regarding governance and the strategic direction of the Group. They also engaged with proxy advisors, regulators and shareholders on issues relating specifically to executive remuneration.

### RELATIONSHIPS WITH RETAIL SHAREHOLDERS

The Company Secretary has a team dedicated to engage with retail shareholders who, with support from the Company's registrar Equiniti Limited, deliver the Group's shareholder service strategy, including the AGM. Group Secretariat provides feedback to the Board and appropriate Committees to ensure the views of retail shareholders are received and considered.

### ANNUAL GENERAL MEETING 2016 AT A GLANCE

The AGM is an opportunity for shareholders to hear directly from the Board on the Group's performance and strategic direction, and importantly, to ask questions.

- nearly 200 shareholders represented
- over 70 per cent of total voting rights voted
- over 97 per cent of votes cast 'in favour' of the Directors' Remuneration Report
- all resolutions voted on by way of a poll

### STATEMENT OF COMPLIANCE

UK Corporate Governance Code - The UK Corporate Governance Code 2014 (the 'Code') applied to the 2016 financial year. The Group confirms that it applied the main principles and complied with all provisions of the Code throughout the year, and that it has applied the UK Corporate Governance Code 2016 since its financial year end. The Code is publicly available at [www.frc.org.uk](http://www.frc.org.uk)

The British Bankers' Association Code for Financial Reporting Disclosure - The Group has adopted the British Bankers' Association's Code for Financial Reporting Disclosure and its 2016 financial statements have been prepared in compliance with its principles.

## CORPORATE GOVERNANCE

## NOMINATION AND GOVERNANCE COMMITTEE REPORT

We are committed to the highest standards of corporate governance, designed to ensure rigour in the Board's discussions and decision making

	<b>Committee meetings</b>	<b>Eligible to Attended attend</b>
<b>Committee Chairman</b>		
Lord Blackwell	5	5
<b>Committee members who served during 2016</b>		
Alan Dickinson	5	5
Anita Frew	5	5
Nick Luff <sup>1</sup>	5	4
Anthony Watson	5	5

<sup>1</sup> Mr Luff was unable to attend the February Committee meeting due to a prior commitment.

A key priority for the Committee, under my leadership, is to keep the composition of the Board and its Committees under review and to make appropriate recommendations to the Board. There were two changes to the Board in 2016. Stuart Sinclair joined the Board in January 2016 and Dyfrig John retired from the Board in May 2016. Stuart's appointment followed that of Deborah McWhinney, who joined the Board in December 2015.

A number of Board changes have been agreed since the year end. Anthony Watson, our Senior Independent Director, will retire at the 2017 AGM after serving more than eight years on the Board, and Nick Luff, an independent Non-Executive Director and Chairman of the Audit Committee, has notified the Board that in light of his other commitments he does not intend to seek re-election at the 2017 AGM. On the Committee's recommendation, the Board has appointed Anita Frew to succeed Anthony as Senior Independent Director, which she will combine with the role of Deputy Chairman. Anita's significant board, financial and investment management experience, including as a Senior Independent

recommendation, the Board has appointed Simon Henry to succeed Nick as Chairman of the Audit Committee. Simon has been a member of the Audit Committee since June 2014 and his background and experience enable him to fulfil the role of Audit Committee Chairman and for SEC purposes the role of Audit Committee financial expert.

The Committee will continue to keep under review the structure, size and composition of the Board and its Committees and to make appropriate recommendations to the Board.

Director, make her ideally suited to take on this role. On the Committee's Another important role for the Committee is ensuring the adequacy of succession planning, including contingency arrangements, both for Board appointments and key senior management roles. An in-depth review was conducted during the year of the Group's talent management approach and succession pipeline and this will continue to be a focus during 2017.

**Lord Blackwell**

Chairman, Nomination and Governance Committee

**COMMITTEE PURPOSE AND RESPONSIBILITIES**

The purpose of the Committee is to keep the Board's governance, composition, skills, experience, knowledge, independence and succession arrangements under review and to make appropriate recommendations to the Board to ensure the Company's arrangements are consistent with the highest corporate governance standards.

The Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. The Committee's terms of reference can be found at [www.lloydsbankinggroup.com/our-group/corporate-governance](http://www.lloydsbankinggroup.com/our-group/corporate-governance)

**COMMITTEE COMPOSITION, SKILLS AND EXPERIENCE**

To ensure a broad representation of experienced and independent Directors, membership of the Committee comprises the Chairman, the Deputy Chairman, who is also the Chairman of the Remuneration Committee, the Senior Independent Director, the Chairman of the Audit Committee and the Chairman of the Risk Committee. The Group Chief Executive attends meetings as appropriate.

**ANNUAL EFFECTIVENESS REVIEW**

During the year, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

## **HOW COMMITTEE MEETINGS ARE RUN**

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 155. Its structure facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committee to consider proposals which are put forward.

## **MATTERS CONSIDERED BY THE COMMITTEE**

During the year the Committee considered a number of issues relating to the Group's governance arrangements, both internal and external. It assisted the Chairman in keeping the composition of the Board and its Committees under review and to lead the appointment process for nominations to the Board.

These issues are summarised on the next page.

164

CORPORATE GOVERNANCE

HOW THE NOMINATION AND GOVERNANCE COMMITTEE SPENT ITS TIME IN 2016

KEY ISSUES	<b>COMMITTEE REVIEW AND CONCLUSION</b>
<b>Board and Committee size and composition</b>	<p>During the year the Committee, led by the Chairman, continued to keep under review the structure, size and composition of the Board and its Committees and to make appropriate recommendations to the Board.</p> <p>The Board should be of sufficient size to reflect a broad range of views and perspectives whilst allowing all Directors to participate effectively in meetings. The Board currently comprises three Executive Directors, nine independent Non- Executive Directors and the Chairman who was independent on appointment.</p> <p>Details of Board changes are set out on page 164.</p>
<b>Succession planning</b>	<p>The Committee, led by the Chairman, continued to keep the adequacy of succession arrangements under review to ensure the desired mix of skills and experience of Board members now and in the future. Full details of the Group’s approach to succession planning can be found on the next page.</p>
<b>Diversity policy</b>	<p>The Committee reviewed the Board Diversity Policy in light of new and emerging best practice and recommended to the Board a specific target to maintain at least three female Board members and to take opportunities to increase the number of female Board members over time. The Board Diversity Policy is set out below.</p>
<b>Effectiveness</b>	<p>The Committee oversaw the annual evaluations of the performance of the Board and its Committees. In January 2016, the Committee reviewed the findings of the 2015 Board Effectiveness Review and recommended actions to the Board to address the areas identified for improvement. Progress against the plan was reviewed during the year. In preparation for the 2016 Board Effectiveness Review, the Committee made recommendations to the Board on the process and timing of the review, which was carried out internally by the Company Secretary. Full details of the 2016 Board Effectiveness Review together with details of the progress against the 2015 review actions are set out on page 160.</p>
<b>Corporate governance</b>	<p>In 2016, the Committee:</p> <ul style="list-style-type: none"> <li>– oversaw the annual review of the Corporate Governance Framework, including the amendments necessary to accommodate the SM&amp;CR and recommended it to the Board for approval</li> <li>– received regular corporate governance updates from the Company Secretary</li> <li>– recommended to the Board a revised share dealing policy for Directors and GEC in light of the new Market Abuse Regulation</li> <li>– reviewed reports from the Chairman on communications from shareholders</li> </ul>

– received updates on the SM&CR

– approved the appointment of Trustees to the Bank’s Foundations

– received updates on ring-fencing governance

In assessing independence, the Committee did not rely solely on the Code criteria but considered whether, in fact, the Non-Executive Director was demonstrably independent and free of relationships and other circumstances that could affect their judgement. It did this with reference to the individual performance and conduct in reaching decisions. It also took account of any relationships that had been disclosed and authorised by the Board.

**Independence  
and time  
commitments**

Based on its assessment for 2016, the Committee is satisfied that, throughout the year, all Non-Executive Directors remained independent as to both character and judgement.

The Committee reviewed the role, including capabilities and time commitment, of the Chairman, Deputy Chairman, Senior Independent Director, Non-Executive Directors, the Group Chief Executive and Executive Directors and found them to be appropriate.

**BOARD DIVERSITY POLICY**

The Board places great emphasis on ensuring that its membership reflects diversity in its broadest sense. A combination of demographics, skills, experience and personal attributes on the Board is important in providing a range of perspectives, insights and challenge needed to support good decision making.

New appointments are made on merit, taking account of the specific skills and experience needed to ensure a rounded Board and the diversity benefits each candidate can bring to the overall Board composition. On gender diversity the Board has a specific target to maintain at least three female Board members and, recognising the emerging target for FTSE companies to move towards 33 per cent female representation, to take opportunities to increase the number of female Board members over time where that is consistent with other skills and diversity requirements.

The Board also places high emphasis on ensuring the development of diversity in the senior management roles within the Group and supports and oversees the Group’s objective of achieving 40 per cent of senior roles held by female executives by 2020, along with other metrics which promote the engagement of other underrepresented groups within the business. This is underpinned by a range of policies within the Group to help provide mentoring and development opportunities for female executives and to ensure unbiased career progression opportunities. Progress on this objective is monitored by the Board and built into its assessment of executive performance.

A copy of the Board Diversity Policy is available on our website at [www.lloydsbankinggroup.com/our-group/responsible-business](http://www.lloydsbankinggroup.com/our-group/responsible-business).



Female representation on the Board is currently 23 per cent (based on three female directors and 10 male directors).  
165

## CORPORATE GOVERNANCE

### OUR APPROACH TO SUCCESSION PLANNING

Good succession planning contributes to the delivery of the Group's strategy by ensuring the desired mix of skills and experience of Board members now and in the future. The Board is also committed to recognising and nurturing talent within executive and management levels across the Group to ensure the Group creates opportunities to develop current and future leaders. The role of succession planning in promoting diversity is recognised and the Group has a range of policies which promote the engagement of underrepresented groups within the business in order to build a diverse talent pipeline.

### BOARD SIZE AND COMPOSITION

Under the leadership of the Chairman, the Committee continued to keep under review the structure, size and composition of the Board and its Committees. At the core of the process is an ongoing assessment led by the Chairman of the collective Board's technical and governance skill set. From this the Chairman creates a board skills matrix which the Committee uses to track the Board's strengths and identify gaps in the desired collective skills profile of Board members, giving due weight to diversity in its broadest sense. Recommendations are made to the Board as appropriate.

### SENIOR MANAGEMENT SUCCESSION

During the year, the Committee, led by the Chairman, also reviewed the succession plans for the Group Chief Executive and other key senior management roles.

The Committee's review was shaped by an in-depth review and broader discussion by the Non-Executive Directors of the Group's talent management approach and succession pipeline for key senior executive roles. This annual talent review allows the Board to identify talent and ensure the Group has the right succession plans and development programmes in place. The review noted the work done to strengthen the approach to talent and development during the year, including the extension of the annual talent review programme and improved tracking and review of succession plans. There was recognition of the further work to be done to continue to increase the diversity of the succession pipeline. The robustness of the succession plans for the Group Chief Executive and other key senior management roles in terms of contingency arrangements and over the medium to longer term were also reviewed.

### BOARD INDUCTION

## DEBORAH MCWHINNEY AND STUART SINCLAIR SHARE THEIR INSIGHTS

Deborah McWhinney and Stuart Sinclair who joined the Board in December 2015 and January 2016 respectively, share their insights on their induction and first year on the Board

### HOW DID THE INDUCTION PROGRAMME HELP YOU PREPARE FOR YOUR ROLE ON THE BOARD?

#### Deborah

I found the programme very well structured and comprehensive. There was a good mix of formal presentations and more informal sessions. It really brought the business and its issues alive for me and, having spent my career in the United States, the tailored and in-depth overview of the UK regulatory landscape was especially instructive.

Colleagues were always very open and willing to spend time with me to ensure my questions were fully answered. The level of openness within the senior management team is reflective of the Group's wider culture.

#### Stuart

I have been through quite a few inductions over the years and what was especially effective about the Group's induction was the mixture of highly structured overviews on key topics such as capital, liquidity and conduct, together with self-selected 'top-ups' and site visits. Attending functions, conferences, product forums, customer focus groups and branches provided valuable context too.

At all times colleagues were welcoming and never failed to find answers to my questions. As a newly appointed Non-Executive Director, I felt that a 'go anywhere, ask anything' culture was apparent.

### HOW WILL YOU REFLECT ON YOUR FIRST YEAR ON THE BOARD?

#### Deborah

I have extensive experience in managing IT operations and digital innovations. I was therefore delighted to be asked to join the new sub-committee of the Board Risk Committee, solely focusing on IT resilience and cyber security, bringing an independence of judgement and challenge to Board discussions.

What also struck me during my first year is the very genuine commitment to diversity in its broadest sense. There is a real understanding that diversity is more than gender, it's a 'frame of mind' that helps bring diversity of thought to Board debate and conversations. I support the Group's diversity programmes through mentoring women in senior roles and by speaking at diversity events.

#### Stuart

I have really enjoyed my first year on the Board because the Group to me was a mixture of relatively familiar topics such as retail network analysis, product testing, capital models and conduct requirements and newer topics such as ring-fencing.

Board and Committee meetings are open, fact-based and collegiate in the best sense: on any given topic there will typically be both experts and generalists. The Board culture works to draw all Directors into the subject, allowing for appropriate consideration and challenge from many angles, which enables an appropriate decision

to be reached.

## CORPORATE GOVERNANCE

**AUDIT COMMITTEE REPORT**

It is the Audit Committee's job to review the integrity of the financial statements and the effectiveness of the internal and external auditor. The Audit Committee has delivered on its responsibilities

	<b>Committee meetings</b>	<b>Eligible to Attended attend</b>
<b>Committee Chairman</b>		
Nick Luff	8 8	
<b>Committee members who served during 2016</b>		
Alan Dickinson	8 8	
Anita Frew	8 8	
Simon Henry	8 4	1
Deborah McWhinney	8 8	
Nick Prettejohn	8 7	2
Anthony Watson	8 8	

Mr Henry was unable to attend Audit Committee meetings in January, July, October and December due to prior executive commitments. Mr Henry will succeed Mr Luff as Audit Committee Chairman following Mr Luff's retirement at the AGM in May 2017. Prior to taking on the Chairmanship of the Audit Committee, Mr Henry is retiring as Chief Financial Officer of Royal Dutch Shell plc in March 2017.

<sup>2</sup>Mr Prettejohn was unable to attend the June Audit Committee meeting due to a prior commitment.

Throughout 2016, the Audit Committee has continued to focus on its key objectives, overseeing financial reporting, internal controls, whistleblowing, and internal and external audit.

The Committee also considered other areas of significant judgement that were relevant to the financial statements. These included other conduct provisions, loan impairments, tax matters, actuarial assumptions for insurance and pension accounting, and the appropriate classification of gilts held by the Group for liquidity purposes. Further details are set out in this report.

Overseeing financial reporting requires an assessment of key accounting judgements and related disclosures. The cost of redress relating to Payment Protection Insurance (PPI) has been substantial, and accounting provisions for this cost remain the most significant judgement made in drawing up the

The transformation of the internal audit function has also been a focus for the Committee. This has included reviewing the scope and direction of internal audit's work, overseeing changes to the

Group's financial statements.

leadership of the function, supporting independence of audit, and encouraging improved reporting of audit findings. The Committee has also monitored the effectiveness of the external audit as the new lead audit partner was introduced.

Estimates of the cost have changed as complaint trends and regulatory factors have evolved. The Committee has reviewed these estimates, and challenged the assumptions behind them, as well as ensuring that appropriate disclosures have been made to explain the uncertainties that remain.

**Nick Luff**

Chairman, Audit Committee

## **COMMITTEE PURPOSE AND RESPONSIBILITIES**

The purpose of the Committee is to monitor and review the Group's financial and narrative reporting arrangements, the effectiveness of the internal controls over financial reporting and the risk management framework, whistleblowing arrangements and each of the internal and external audit processes.

The Audit Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. A full list of responsibilities is detailed in the Committee's terms of reference, which can be found at [www.lloydsbankinggroup.com/our-group/corporate-governance](http://www.lloydsbankinggroup.com/our-group/corporate-governance)

## **COMMITTEE COMPOSITION, SKILLS AND EXPERIENCE**

The Committee acts independently of the executive to ensure that the interests of the shareholders are properly protected in relation to financial reporting and internal control.

All members of the Committee are independent Non-Executive Directors with competence in the financial sector with the Committee as a whole having competence relevant to the financial sector. Nick Luff is a Chartered Accountant and has significant financial experience in the UK listed environment enabling him to fulfil the role of Audit Committee Chairman, for the purposes of the UK Corporate Governance Code (the 'Code') as a member having recent and relevant financial experience, and for SEC purposes, the role of Audit Committee financial expert. In addition, Simon Henry is a Chartered Global Management Accountant and has extensive knowledge of financial markets, treasury and risk management, and also qualifies as a member having recent and relevant financial experience under the Code and an Audit Committee financial expert under SEC rules.

## **HOW COMMITTEE MEETINGS ARE RUN**

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 155. Its structure facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committee to consider proposals which are put forward.

During the course of the year, the Committee held separate sessions with the internal and external audit teams, without members of the executive management present.

Based on the outcome of the annual board effectiveness review in 2015 additional training for Committee members has been introduced. Targeted training on risk weighted assets, derivative accounting, IFRS9 and insurance accounting has been provided. This year's annual effectiveness review confirmed the Committee met its key objectives and carried out its responsibilities effectively.

## CORPORATE GOVERNANCE

Whilst the Committee's membership comprises the Non-Executive Directors noted above, all Non-Executive Directors may attend meetings as agreed with the Chairman of the Committee. The Interim Group Audit Director, the external auditor, the Group Chief Executive, the Chief Financial Officer and the Chief Risk Officer also attend meetings of the Committee as appropriate.

During the year the Committee considered a number of issues relating to the Group's financial reporting, these issues are summarised below, including discussion of the conclusions the Committee reached, and the key factors considered by the Committee in reaching its conclusions.

In addition, the Committee considered a number of other significant issues not related directly to financial reporting, including internal controls, internal audit and external audit. These issues are also discussed in detail in the next section, including insight into the key factors considered by the Committee in reaching its conclusions.

## MATTERS CONSIDERED BY THE COMMITTEE

### HOW THE AUDIT COMMITTEE SPENT ITS TIME IN 2016

#### FINANCIAL REPORTING

During the year, the Committee considered the following significant financial issues in relation to the Group's financial statements and disclosures, with input from management, Group Audit and the external auditor:

#### KEY ISSUES

##### **Payment Protection Insurance (PPI)**

In determining the adequacy of the provision for redress payments and administration costs in connection with the mis-selling of PPI the Group makes a number of assumptions based on management judgement. Such assumptions include the number of future complaints that will be received and the extent to which they will be upheld; average redress payments; and related administrative costs.

#### COMMITTEE REVIEW AND CONCLUSION

– The Committee continued to challenge the assumptions made by management to determine the provision for PPI redress and administration costs. The Committee oversaw continued use of sensitivities reflecting the uncertainty that remains around the ultimate cost of PPI redress.



The Group provided a further £1,350 million to cover further operating costs and redress, including the impact of an August 2019 industry deadline. To 31 December 2016, the Group has provided a total of £17,375 million in respect of PPI mis-selling redress and administration costs.

– The Committee also reviewed management’s assessment of the impact of the Financial Conduct Authority’s industry deadline of August 2019 for consumers to make their PPI complaints and final rules and guidance that should apply when firms handle complaints in light of the decision in the Plevin case.

– Group Audit undertook periodic agreed upon procedures over the process used by management to calculate the PPI provision. Procedures undertaken were designed to identify the use of reasonable, consistent and supportable assumptions and inputs. No items were raised by exception for consideration by the Committee.

– The Committee concluded that the provision for PPI redress and the Group’s external disclosures were appropriate.

– The disclosures relating to PPI are set out in note 38: ‘Other provisions’ on page F-56 of the financial statements.

– For packaged bank accounts, the Committee has continued to monitor the utilisation of the provision and management’s assessment of both the remaining exposure and the additional provisions required. This has included reviewing the expected level of complaints and the average redress payments.

– The Committee has understood the basis for determining the provision in respect of the Group’s secured and unsecured arrears handling activities. The provision includes the cost of both identifying and rectifying the customers affected.

– Group Audit undertook periodic agreed upon procedures over the process that has been used by management to calculate the extent of conduct related provisions. Procedures undertaken were designed to identify the use of reasonable, consistent and supportable assumptions and inputs. No items were raised by exception for consideration by the Committee.

### **Other conduct provisions**

The Group has also made provisions totalling £1,085 million in respect of other conduct matters, including £280 million for packaged bank accounts and £261 million for secured and unsecured arrears handling activities.

- The Committee was satisfied that the provisions for other conduct matters were appropriate. The disclosures relating to other conduct provisions are set out in note 38: ‘Other provisions’ on page F-56 of the financial statements.
- The Committee challenged the level of provisions made and the assumptions used to calculate the impairment provisions held by the Group.

**Allowance for impairment losses on loans and receivables**

Determining the appropriateness of impairment losses requires the Group to make assumptions based on management judgement.

- Group Audit has provided assurance to the Audit Committee that the impairment governance processes are effective.

- The Committee was satisfied that the impairment provisions were appropriate. The disclosures relating to impairment provisions are set out in note 52: ‘Financial risk management’ on page F-87 of the financial statements.

CORPORATE GOVERNANCE

**KEY ISSUES**

**Recoverability of the deferred tax asset**

A deferred tax asset can be recognised only to the extent that it is recoverable. The recoverability of the deferred tax asset in respect of carry forward losses requires consideration of the future levels of taxable profit in the Group.

**Uncertain tax positions**

The Group has open tax matters which require it to make judgements about the most likely outcome for the purposes of calculating its tax position.

**Retirement benefit obligations**

The Group must make both financial and demographic assumptions of a judgemental nature to determine the value of the defined benefit obligation.

**Value-In-Force (VIF) asset and insurance liabilities**

Determining the value of the VIF asset and insurance liabilities is judgemental and requires economic and non-economic actuarial assumptions.

**COMMITTEE REVIEW AND CONCLUSION**

– The Committee considered the recognition of deferred tax assets, in particular the forecast taxable profits based on the Group’s operating plan, the split of these forecasts by legal entity and the Group’s long-term financial and strategic plans.

– The Committee agreed with management’s judgement that the deferred tax assets were appropriately supported by forecast taxable profits, taking into account the Group’s long-term financial and strategic plans. The disclosures relating to deferred tax are set out in note 37: ‘Deferred tax’ on page F-53 of the financial statements.

– The Committee took account of the respective views of both management and the relevant tax authorities when considering the uncertain tax positions of the Group. The Committee also understood the external advice obtained by management to support the views taken.

– The Committee was satisfied that the provisions and disclosures made in respect of uncertain tax positions were appropriate. The relevant disclosures are set out in note 48: ‘Contingent liabilities and commitments’ on page F-68 of the financial statements.

– The Committee considered the financial and demographic assumptions used to determine the defined benefit liabilities, in particular mortality assumptions and the discount rate, which have been updated to reflect recent experience.

– The Committee was also satisfied that the Group’s quantitative and qualitative disclosures made in respect of retirement benefit obligations are appropriate. The relevant disclosures are set out in note 36: ‘Retirement benefit obligations’ on page F-47 of the financial statements.

– The Committee challenged the economic and non-economic actuarial assumptions made by management which underpin the calculation of the VIF asset and the insurance liabilities. The Committee also reviewed the movements in the key assumptions since 31 December 2015.

- The Committee was satisfied that the value of the VIF asset and insurance liabilities were appropriate. The disclosures are set out in note 24: ‘Value of in-force business’ on page F-38 and note 32: ‘Liabilities arising from insurance contracts and participating investment contracts’ on page F-42 of the financial statements.
- During the year, the Group reclassified approximately £20 billion of gilts within the liquidity portfolio as ‘available-for-sale’; the gilts were previously classified as ‘held-to-maturity’.

### **Reclassification of gilts held within the liquidity portfolio**

Determining the appropriate accounting treatment for gilts held within the liquidity portfolio.

- The Committee considered and was satisfied with management’s assessment of the circumstances which support the reclassification of the gilts, the appropriateness of the accounting treatment and related disclosure.

### **One-off transactions**

Determining the appropriate accounting for certain one-off transactions requires management to assess the facts and circumstances specific to each transaction.

- The disclosure is set out in note 49: ‘Financial instruments’ on page F-71 of the financial statements.
- The sale of Visa Europe is one example of one-off transactions considered by the Audit Committee during the year.

- The Committee was satisfied that the accounting treatment of the sale was appropriate.

## **OTHER SIGNIFICANT ISSUES**

The following matters were also considered by the Committee:

### **RISK MANAGEMENT AND INTERNAL CONTROL SYSTEMS**

Full details of the internal control and risk management systems in relation to the financial reporting process are given within the risk management section on pages 44 to 112. Specific matters that the Committee considered during the year included:

- the effectiveness of systems for internal control, financial reporting and risk management;

–

the extent of the work undertaken by the Finance teams across the Group and consideration of the resources to ensure that the control environment continued to operate effectively;

the major findings of internal investigations into control weaknesses, fraud or misconduct and management's response –along with any control deficiencies identified through the assessment of the effectiveness of the internal controls over financial reporting under the US Sarbanes- Oxley Act.

The Committee was satisfied that internal controls over financial reporting were appropriately designed and operating effectively.

## GROUP AUDIT

In monitoring the activity, role and effectiveness of the internal audit function and their audit programme the Committee:

–monitored the effectiveness of Group Audit and their audit programme through quarterly reports on the activities undertaken and a report from the Quality Assurance function within Group Audit;

–approved the annual audit plan and budget and reviewed progress against the plan through the year;

–oversaw the process for the appointment of an Interim Group Audit Director; and

–considered the major findings of significant internal audits, and management's response.

## CORPORATE GOVERNANCE

### SPEAK UP (THE GROUP'S WHISTLEBLOWING SERVICE)

The Committee received and considered reports from management on the Group's whistleblowing arrangements including summaries of cases and ongoing reviews of the Whistleblowing Governance Structure. On consideration of the reports submitted, the Committee was satisfied with the actions which had been taken, the report first having been considered and approved by the Board's Whistleblowing Champion, Anita Frew.

### AUDITOR INDEPENDENCE AND REMUNERATION

Both the Board and the external auditor have safeguards in place to protect the independence and objectivity of the external auditor. In 2016 the Audit Committee approved an amended policy to regulate the use of the auditor for non-audit services to ensure compliance with the revised Ethical Standards for Auditors from the Financial Reporting Council (FRC).

In order to ensure the objectivity and independence of the external auditor, the policy sets a financial threshold above which all non-audit services provided by the external auditor must be approved in advance by the Committee, with additional provision made for the approval of non-material services which are below the threshold by certain members of senior management. The policy further formalises within the Group the restriction on the provision of non-audit services by the external auditor which the FRC consider to be prohibited.

The total amount of fees paid to the auditor for both audit and non audit related services in 2016 is disclosed in note 11 to the financial statements on page F-26.

### EXTERNAL AUDITOR

The Committee oversees the relationship with the external auditor. During the year, the Committee considered the auditors' terms of engagement (including remuneration), their independence and objectivity and approved the audit plan (including methodology and risk identification processes).

In accordance with regulations there was a change of lead audit partner.

The Committee also considered the effectiveness and performance of the auditor and the audit process.

These assessments considered data and information from a number of sources including:

- the results of an internal effectiveness survey; and
- the FRC's Audit Quality Inspection Report (AQIR) on PwC published in May 2016.

The Committee concluded that it was satisfied with the auditor's performance and recommended to the Board a proposal for the reappointment of the auditor, to be approved at the Company's AGM.

#### STATUTORY AUDIT SERVICES COMPLIANCE

The Company and the Group confirm compliance with the provisions of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 for the year to 31 December 2016.

PwC have been auditor to the company and the Group since 1995, having previously been auditor to certain of the Group's constituent companies. PwC were re-appointed as auditor with effect from 1 January 2016 following a tender process conducted during 2014. There will be a mandatory rotation for the 2021 audit, if not earlier.

## CORPORATE GOVERNANCE

**BOARD RISK COMMITTEE REPORT**

The Committee has continued to take a dynamic approach to the consideration of existing and emerging risks.

	<b>Committee meetings</b>		
	<b>Eligible to attend</b>	<b>Attended</b>	
<b>Committee Chairman</b>			
Alan Dickinson	8	8	
<b>Committee members who served during 2016</b>			
Lord Blackwell	8	8	
Anita Frew	8	8	
Simon Henry	8	7	1
Nick Luff	8	7	2
Deborah McWhinney	8	8	
Nick Prettejohn	8	8	
Stuart Sinclair	8	8	
Anthony Watson	8	8	
Sara Weller	8	8	
<b>Former Committee members who served during 2016</b>			
Dyfrig John <sup>3</sup>	4	4	

1 Mr Henry was unable to attend the May Risk Committee meeting due to prior executive commitments.

2 Mr Luff was unable to attend the July Risk Committee meeting due to prior executive commitments.

3 Mr John retired on 11 May 2016.

I am pleased to report on how the Board Risk Committee has discharged its responsibilities throughout 2016.

The Committee has continued to take a dynamic approach to the consideration of existing and emerging risks, through a balanced agenda which included standing areas of risk management, together with specific focus on emerging risks focusing significant additional resource where considered necessary. An example of this has been the establishment of dedicated sub-committees to further enhance focus on particular areas, such as IT resilience and cyber security, enabling members of the Committee to direct more time to better understand, and challenge, the associated risks and actions being taken by management.



The Committee has continued to build upon the progress reported last year around furthering the understanding of complex risks and seeking to enhance risk management. I am pleased to report that good progress continued to be made throughout 2016 in reducing risks across the Group's material lending portfolios within both the

Mortgage and Commercial businesses. The Committee will continue to review progress and developments during 2017.

The Group continues to operate in an environment subject to considerable change and, during 2016, another key area of activity for the Committee has been the proactive review, oversight and management of risks arising from the outcome of the EU referendum and wider geo-political risks. The Committee will continue to monitor developments and any impact on the Group's risk profile.

The Committee has concluded, through its detailed work, that the Group continues to have strong discipline in the management of both emerging and existing risks, and the Committee's work continues to help support the Group in achieving its core aim of operating as a safe, low risk bank.

**Alan Dickinson**

Chairman, Board Risk Committee

**Committee purpose and responsibilities**

The purpose of the Board Risk Committee is to review the risk culture of the Group, setting the tone from the top in respect of risk management. The Committee is also responsible for ensuring the risk culture is fully embedded and supports at all times the Group's agreed risk appetite, covering the extent and categories of risk which the Board considers as acceptable for the Company.

In seeking to achieve this, the Committee assumes responsibility for monitoring the Group's Risk Management Framework, which embraces risk principles, policies, methodologies, systems, processes, procedures and people. It also includes the review of new, or material amendments to risk principles and policies, and overseeing any action resulting from material breaches of such policy.

More details on the Group's wider approach to risk management can be found in the risk management section on pages 44 to 112. Full details of the Committee's responsibilities are set out in its terms of reference, which can be found at [www.lloydsbankinggroup.com/our-group/corporate-governance](http://www.lloydsbankinggroup.com/our-group/corporate-governance)

**Committee composition, skills and experience**

Alan Dickinson, Chairman of the Committee, is a highly regarded retail and commercial banker, having spent 37 years with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK, overseeing the group's Retail and Commercial operations in the UK. The Committee is composed of independent Non-Executive Directors, who provide core banking and risk knowledge, together with breadth of experience which brings knowledge from other sectors, and a clear awareness of the importance of putting the customer at the centre of all that the Group does.

Since January 2016, all Non-Executive Directors have been members of the Board Risk Committee. The Chief Risk Officer has full access to the Committee and attends all meetings. The Interim Group Audit Director and members of the Executive also attend meetings as appropriate.

During the year the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

## CORPORATE GOVERNANCE

### **How Committee meetings are run**

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 155, with a structure which facilitates open discussion and debate. Steps are taken to ensure adequate time for members to consider proposals which are put forward.

As the most senior risk forum in the Group, the Committee interacts with other related risk forums, including the Executive Group Risk Committee. Such interaction assists with the agenda planning process, where in addition to annual agenda planning, matters considered by the Group Risk Committee are reviewed to ensure escalation of all relevant matters to the Board Risk Committee.

### **Matters considered by the Committee**

Over the course of the year the Committee considered a wide range of risks facing the Group, both standing and emerging, across all key areas of risk management, in addition to risk culture and risk appetite, as noted above.

As part of this review, certain risks were identified which required further detailed consideration. Set out below is a summary of these risks, with an outline of the material factors considered by the Committee, and the conclusions which were ultimately reached.

In addition, during 2016, two further sub-committees of the Board Risk Committee were established to focus on Financial Markets and IT Resilience & Cyber, in addition to an existing Stress Testing & Recovery Planning sub-committee. The sub-committees were constituted to enable members of the Board Risk Committee to dedicate additional time and resource to better understand and to enable fuller review and challenge of the risks associated with the topic of the sub-committee.

#### **KEY ISSUES** **EU referendum**

The Committee regularly reviewed a range of lead economic and Key Performance Indicators across the portfolios, to help identify any early signs of deterioration in the economy and the Group's credit risk profile.

#### **COMMITTEE REVIEW AND CONCLUSION**

As a result of the referendum outcome and to manage the impact of uncertainty caused by the referendum process and ensuing economic concerns, detailed EU exit portfolio assessments were undertaken to understand potential impacts on the Bank's credit risk profile and to assess the potential need for any changes to Group risk appetite. Additional regular monitoring of internal and external early warning and key performance indicators was instigated and continues to be closely monitored by the Committee to track any adverse movement in the risk profile of the Retail and Commercial portfolios, and to ensure that risk appetite remains appropriate.

Conclusion: Regular monitoring continues to assist the Committee in its assessment of the portfolios, with management continuing to take action to mitigate potential risks associated with the EU exit decision. Key credit risks continue to be well managed through strong, effective risk management and risk appetite, including early identification and management of potential concern customers.

### **Cyber risk and IT resilience**

A resilient IT environment is critical to providing reliable services to customers and enabling sustainable growth. The dynamic threat posed by cyber risk and the potential for external attacks on the integrity of electronic data or the availability of systems are key risks for the Group and central area of focus for the Committee.

Given the dynamic nature and significance of IT and cyber risks the Committee has established a sub-committee to enable more in depth consideration of IT resilience and cyber risks. During the year the sub-committee gave consideration to a wide range of issues including insider risk, cyber reverse stress testing, IT Resilience and Cyber Programme updates, cyber insurance and cloud technology. Alongside this an advisory panel comprising external industry experts has been established to provide the sub-committee with an external view of current and evolving industry wide cyber security threats, challenges and developments.

Conclusion: Much has been achieved in respect of IT resilience and cyber security initiatives and the focus given by the Committee during 2016 has raised awareness across the Group. However, IT resilience and cyber security risk will remain a key area of focus for the Committee in 2017. Throughout 2016, the Committee considered reports on the proactive identification and resolution of conduct issues which have had an impact on customers. The pace and quality of required remediation received particular attention together with actions taken to address root cause analysis and the prevention of similar issues. Consideration was also given to the conduct risks within the collections process for customers in arrears as well as customers in financial difficulties. In addition the Committee considered developments in the Group's conduct culture as well as reports

### **Conduct risk**

The Committee continues to focus closely on the Group's approach to conduct risk.

on complaints, conduct risk appetite metrics and product governance.

Conclusion: Whilst good progress has been made as a result of the Group's conduct strategy initiatives, continued improvement in the Group's conduct risk profile will remain a priority for the Group in 2017 and will continue to be a subject of focus for the Committee.

### **UK Secured and buy-to-let**

Regular reviews were undertaken of the risks associated with the UK Secured portfolio, including specifically the buy-to-let segment.

In reviewing the UK Secured portfolio, consideration was given to the quality of new lending, the credit performance of the portfolio, the risk adjusted returns, and the adequacy of impairment and capital provisions under both expected and stressed conditions. The Committee specifically considered appetite for higher loan to value lending following the government's announcement to discontinue the Help to Buy 2 scheme. Additionally, for the buy-to-let segment, the Committee reviewed management's plans to implement changes in response to the revised tax regime and additional regulatory requirements for underwriting.

Conclusion: The Group's mortgage portfolio remains well balanced, with overall debt to value ratios having improved and concentration risks reduced. Management continues to take appropriate action to address the risks arising from these portfolios and the Committee will continue to review developments during the course of 2017.

CORPORATE GOVERNANCE

**KEY ISSUES**

**Data risk**

Data risk has been identified as a key focus within the Group to take into account the growing importance of data as a means of competitive advantage and to underpin key risk decision making and risk management.

**Residual value risk**

A review of the impact of used car prices on the residual value risk of motor finance businesses was undertaken.

**Stress testing**

The review of stress testing exercises and their results continued to be a key area of focus during the year.

**COMMITTEE REVIEW AND CONCLUSION**

The Committee continued to focus attention on key data initiatives within the Group. The Committee considered a number of reports on data risk throughout 2016 covering, amongst other topics, user access management, risk data aggregation and reporting and data privacy, all of which have impacts across the Group. Additionally, regular reporting on data risk, as a distinct risk type, has been introduced in 2016 in recognition of the growing importance of data as an asset to the Group as well as the forthcoming EU General Data Protection Regulation (GDPR).

**Conclusion:** Improvement to risk data systems, governance and controls over the last two years have strengthened risk reporting, whilst there remains opportunity to develop further. Data risk will remain a key area of focus for the Committee in 2017 in line with the growing importance of data as an asset to the Group and maturity of the Group Chief Data Office.

Given the increased uncertainty around used car prices in the current market environment, consideration was given to the residual value risk associated with the Group's growing motor finance businesses and the impact of a range of possible scenarios for the future path of used car prices and deteriorating macro environment.

**Conclusion:** The combination of pricing that reflects the future value of vehicles, and prudent provisioning, appropriately reflects potential risk. The Committee introduced a new risk appetite limit to reflect planned business growth and manage the concentration of residual value risk. The Committee will continue to monitor this throughout 2017.

The Committee reviewed a diverse set of stress testing scenarios in 2016, including internally defined moderate and severe economic downturns, reverse stress test events including a large scale cyber-attack and external scenarios set by the Bank of England and the European Banking Authority.

The assessment included a review of the resilience of the Group, including specific areas of focus such as credit risk as well as impacts on the Group's capital and liquidity positions. An assessment of the impact on dividends and mitigating actions proposed by management in each scenario was also undertaken.

**Conclusion:** The Group's capital and liquidity positions remained above required minimums and the relevant risk appetite metric, with outcomes reflecting the ongoing de-risking by the Group. The implementation and assessment of robust

and well managed stress testing arrangements will remain a key area of focus for the Committee in the coming year.

Assessment was made of the overall governance framework for models including scope, the model landscape, the role of the Group Model Governance Committee and modelling standards. Additionally, the Committee considered the Group's material models at Divisional level, including their purpose, design and how regular performance monitoring and validation ensure they remain fit-for-purpose and identify areas for improvement in an evolving regulatory environment. The Committee also observed a structured reporting framework which facilitates good senior management awareness and escalation, when required.

### **Model risk**

The approach to model risk management, including the Group's model governance framework, material models and regulatory requirements were reviewed.

Conclusion: The Group's management of model risk is robust with a strong control framework, consisting of specialist teams, regular performance monitoring, annual validation and appropriate escalation of issues. Model risk will continue to be an area of focus for the Committee via regular reporting, including risk appetite measures.

The Committee continued to provide oversight of the risks in the Commercial Banking portfolios via a regular update on the credit quality in key sectors such as Commercial Real Estate, Acquisition Finance and SME as well as oversight of large single name exposures.

### **Commercial Banking portfolios**

The Committee considered a range of regular and ad-hoc papers covering key risks associated with the Commercial Banking portfolios.

Additional topics covered in 2016 included country risk, the potential impact of the EU referendum, a review of the exposure to European Banks and deep dives in to the oil and gas sector. There was also increased focus on the Financial Markets business and the associated traded market risk through a newly created sub-committee.

Conclusion: Regular and cyclical assessments of key portfolios has assisted the Committee in its oversight of risk management within Commercial Banking and any impact arising from both existing and emerging risks. Management continues to take satisfactory action to mitigate and address risks and the Committee will continue to review core aspects of the Commercial Banking business during 2017.

## CORPORATE GOVERNANCE

**RESPONSIBLE BUSINESS COMMITTEE REPORT**

Being a responsible business is fundamental to our strategy. We are proud that our colleagues support so many people, businesses and communities across the UK to achieve a better future through the work of our Helping Britain Prosper Plan

	Committee meetings	
	Eligible to attend	Attended
<b>Committee Chairman</b>		
Sara Weller	5	5
<b>Committee members who served during 2016</b>		
Lord Blackwell	5	5
Anita Frew	5	4 1

1 Ms Frew was unable to attend the Committee meeting in April 2016 due to a prior business commitment

I am pleased to present the second Responsible Business Committee report, following its establishment in July 2015.

Responsible Business practices are fundamental building blocks of our strategy, and the Committee has made good progress in continuing to support the embedding of responsible business activities during 2016.

The Committee focuses its work on the three areas of People, Businesses and Communities. At each meeting we explore in depth the progress made towards achieving the Group's purpose of helping Britain prosper, through becoming the best bank for customers.

Key areas reviewed have been: work to deepen our customer-centric culture; programmes to tackle disadvantage, including through our Foundations, our role in supporting UK businesses build for the future; and the development of the programme of skills-based volunteering undertaken by colleagues across the Group.



The Committee is supported in its work by two business-wide committees which report to the Group Chief Executive: the Group Customer First Committee and the Responsible Business Management Committee. Information on the work of these committees can be found on page 51.

I welcomed the opportunity during the year to get involved in responsible business activities in different parts of the country, including taking part in a panel for the School for Social Entrepreneurs (more detail on page 175). And I very much enjoyed meeting the profoundly deaf founder of the Yumma Café, a catering business aimed specifically at supporting deaf people. This was a great example of how the personal experience which drives many social entrepreneurs is making a significant difference. I would like to thank all those who attended our meetings this year for their support.

I would like to thank all the Board Directors and executives who attended and contributed to the Committee during the year. Most of all, I would like to recognise the tremendous contribution of our colleagues who have given their support to people, businesses and communities across the country, to help Britain prosper.

**Sara Weller**

Chairman, Responsible Business Committee

## **COMMITTEE COMPOSITION AND EFFECTIVENESS**

The membership of the Committee comprises Sara Weller, independent Non-Executive Director (Chairman of the Committee) the Group Chairman and the Deputy Chairman. All Non-Executive Directors are invited to attend the Committee's meetings. The Group Chief Executive attended two meetings in 2016. During the year, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

## **THE OPERATION OF THE COMMITTEE**

Committee meetings are managed in accordance with the principles outlined on page 155 for the management of Board agendas and meetings. These principles are intended to facilitate open debate and constructive challenge. The Committee Chairman reviews the draft agenda regularly to ensure that adequate time is devoted to issues of interest to Committee members and that its key responsibilities are addressed. The Committee Chairman reports regularly to the Board on the Committee's work and presents the Helping Britain Prosper Plan to the Board for approval prior to publication.

## **HOW THE COMMITTEE SPENT ITS TIME IN 2016**

The Committee has reviewed and discussed the following topics:

the development of the Group's responsible business strategy, with input from the Group Chief Executive  
the Group's approach to measuring stakeholder and customer trust against its peers in financial services and  
acknowledged leaders in generating trust  
the continuing development of the Group's culture programme, in conjunction with the Board  
the results of colleague surveys as they relate to the Group's responsible business activities  
the steps taken to identify vulnerable customers and to ensure the Group's products and customer service approach  
take account of their varying needs  
the initiatives in place to tackle financial disadvantage amongst customers and to promote financial and digital  
inclusion  
the work of the School for Social Entrepreneurs and the Schools Activity Programme  
a report on the Group's charitable Foundations, and their planned future activities, from the Chief Executive of the  
Lloyds Bank Foundation for England and Wales  
the Group's responsible and sustainable finance approach, including the creation of the Green Loan Initiative and the  
work being done to develop innovative solutions to meet the increasing demand of customers for responsible lending  
products

## **RESPONSIBLE BUSINESS COMMITTEE AND EXTERNAL STAKEHOLDERS**

The members of the Committee have an ongoing dialogue with key stakeholders with an interest in the Committee's activities. Committee members look forward to engaging with key stakeholders, including the independent Stakeholder Panel, in 2017.

CORPORATE GOVERNANCE

**RESPONSIBLE BUSINESS IN ACTION: SCHOOL FOR SOCIAL ENTREPRENEURS**

The Lloyds Bank and Bank of Scotland Social Entrepreneurs programme is delivered through a partnership with the School for Social Entrepreneurs and the Big Lottery. The programme aims to support 2,000 social entrepreneurs by 2020.

In July 2016, Sara Weller was asked to join a panel to select the next cohort of 21 Social Entrepreneurs to secure a place on the programme. This was an opportunity to understand how each of the social entrepreneurs is supported through a 12 month package comprising a series of interactive learning sessions, a senior colleague from within Lloyds Bank to support them as they develop their social business, and a small grant.

The panel membership comprised local colleagues, representatives from the SSE Dartington school and a member of South Gloucestershire Council. Each candidate ‘pitches’ their social business idea for three minutes before being interviewed by the panel.

The programme attracts a diverse array of applicants, ranging from an artisan bakery providing employment opportunities for young adults with learning difficulties to an artists’ space dedicated to tackling problems of isolation through arts and creativity.

**DISCLOSURE CONTROLS AND PROCEDURES**

As of 31 December 2016, Lloyds Banking Group, under the supervision and with the participation of the Group’s management, including the Group Chief Executive and the Chief Financial Officer, performed an evaluation of the effectiveness of the Group’s disclosure controls and procedures. Based on this evaluation, the Group Chief Executive and Chief Financial Officer concluded that the Company’s disclosure controls and procedures, at 31 December 2016, were effective for gathering, analysing and disclosing with reasonable assurance the information that Lloyds Banking Group is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC’s rules and forms. The Lloyds Banking Group’s management necessarily applied its judgement in assessing the costs and benefits of such controls and procedures, which by their nature can provide only reasonable assurance regarding management’s control objectives.

CORPORATE GOVERNANCE

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There have been no changes in the Lloyds Banking Group's internal control over financial reporting during the year ended 31 December 2016 that have materially affected, or are reasonably likely to materially affect, the Lloyds Banking Group's internal control over financial reporting.

**MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of Lloyds Banking Group plc is responsible for establishing and maintaining adequate internal control over financial reporting. Lloyds Banking Group plc's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with IFRS and that receipts and expenditures are being made only in accordance with authorisations of management and directors of Lloyds Banking Group plc; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Internal control systems, no matter how well designed, have inherent limitations and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

The management of Lloyds Banking Group plc assessed the effectiveness of the Company's internal control over financial reporting at 31 December 2016 based on the criteria established in Internal Control – Integrated Framework 2013 issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). Based on this assessment, management concluded that, at 31 December 2016, the Company's internal control over financial reporting was effective.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has issued an audit report on the Company's internal control over financial reporting as of 31 December 2016. This report appears on page F-2.

## **GOING CONCERN**

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: funding and liquidity on page 42 and pages 95 to 100 and capital position on pages 101 to 108 and additionally have considered projections for the Group's capital and funding position. Accordingly, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

176

## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### MAJOR SHAREHOLDERS

As at 31 December 2016, 31 December 2015 and 31 December 2014, the Company had received notification from The Solicitor for the Affairs of Her Majesty's Treasury (HM Treasury) that it had a direct interest of 6.93 per cent, 9.9 per cent and 24.9 per cent respectively in the Company's issued ordinary share capital with rights to vote in all circumstances at general meetings. Subsequent to 31 December 2016, the Company has received notifications from The Solicitor for the Affairs of Her Majesty's Treasury (HM Treasury) on 6 January 2017, 27 January 2017 and 22 February 2017 that its direct interest in the Company's issued ordinary share capital had reduced to 5.95 per cent, 4.998 per cent and then to 3.89 per cent respectively. Based solely on the Schedule 13-G filed by BlackRock, Inc. with the US Securities and Exchange Commission dated 24 January 2017, as at 31 December 2016, BlackRock, Inc. beneficially owned 6.4 per cent (representing 4,566,352,317 ordinary shares) of the Company's issued ordinary share capital. As at 24 February 2017 no other notification has been received that anyone has an interest of 3 per cent or more in the Company's issued ordinary share capital. Further information on HM Treasury's shareholding in the Company is provided in *Business – History and development of Lloyds Banking Group*.

All shareholders within a class of the Company's shares have the same voting rights.

As at 31 December 2016, the Company had 2,509,505 registered ordinary shareholders. The majority of the Company's ordinary shareholders are registered in the United Kingdom. 1,803,454,609 ordinary shares, representing 2.53 per cent of the Company's issued share capital, were held by BNY Mellon as depositary for the ordinary share American Depositary Share Programme through which there were 178 record holders.

Additionally, the majority of the Company's preference shareholders are registered in the United Kingdom, with a further one record holder with an address in the United States registered through the Company's preference share American Depositary Share Programme.

### RELATED PARTY TRANSACTIONS

The Group, as at 31 December 2016, had related party transactions with 21 key management personnel, certain of its pension funds, collective investment schemes and joint ventures and associates. See note 47 to the financial statements.

## REGULATION

### **APPROACH OF THE FINANCIAL CONDUCT AUTHORITY (FCA)**

As per the Financial Services and Markets Act 2000 (FSMA) (amended by the Financial Services Act 2012), the FCA has a strategic function to ensure that the relevant markets function well. In support of this, the FCA has three operational objectives: to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK financial system and to promote effective competition in the interests of consumers.

The FCA Handbook sets out rules and guidance across a range of conduct issues with which financial institutions are required to comply including high level principles of business and detailed conduct of business standards and reporting standards.

### **REGULATORY APPROACH OF THE PRA**

As per the Financial Services Act 2012, the PRA has two statutory objectives: to promote the safety and soundness of the firms which it supervises and, with respect to insurers, to contribute to the securing of an appropriate degree of protection for policyholders. The PRA's regulatory and supervisory approach incorporates three key characteristics: to take a judgement-based approach, a forward-looking approach, and a focused-approach.

The PRA has largely inherited the prudential aspects of the former FSA Handbook, including regulations and guidance relating to capital adequacy and liquidity among several other things.

### **OTHER BODIES IMPACTING THE REGULATORY REGIME**

#### **THE BANK OF ENGLAND AND HM TREASURY**

The agreed framework for co-operation in the field of financial stability in the financial markets is detailed in the Memorandum of Understanding published jointly by HM Treasury, the FCA (formerly the FSA) and the Bank of England (now including the PRA) (together, the "Tripartite Authorities"). The Bank of England has specific responsibilities in relation to financial stability, including: (i) ensuring the stability of the monetary system; (ii) oversight of the financial system infrastructure, in particular payments systems in the UK and abroad; and (iii) maintaining a broad overview of the financial system through its monetary stability role. The Bank also wholly

incorporates the PRA.

#### UK FINANCIAL OMBUDSMAN SERVICE (FOS)

The FOS provides consumers with a free and independent service designed to resolve disputes where the customer is not satisfied with the response received from the regulated firm. The FOS resolves disputes for eligible persons that cover most financial products and services provided in (or from) the UK. The jurisdiction of the FOS extends to include firms conducting activities under the Consumer Credit Act (CCA). Although the FOS takes account of relevant regulation and legislation, its guiding principle is to resolve cases on the basis of what is fair and reasonable; in this regard, the FOS is not bound by law or even its own precedent. The decisions made by the FOS are binding on regulated firms.

#### THE FINANCIAL SERVICES COMPENSATION SCHEME (FSCS)

The FSCS was established under the FSMA and is the UK's statutory fund of last resort for customers of authorised financial services firms. Companies within the Group are responsible for contributing to compensation schemes in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers. The FSCS can pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it. The FSCS is funded by levies on firms authorised by the PRA and the FCA, including companies within the Group.

#### LENDING STANDARDS BOARD

The Lending Standards Board (formerly the Banking Code Standards Board) is responsible for monitoring and enforcing compliance with the Standards of Lending Practice (which replaced the voluntary Lending Code on 1 October 2016). The standards relate to certain lending (current account overdrafts, loans and credit cards) to consumers, micro-enterprises and charities with an income of less than £1 million.

#### UK COMPETITION AND MARKETS AUTHORITY (CMA)

Since 1 April 2014 the competition functions previously exercised by the Office of Fair Trading and the Competition Commission have been transferred to the new CMA or the FCA. The CMA's regulatory and enforcement powers impact the banking sector in a number of ways, including powers to investigate and prosecute a number of criminal offences under competition law. In addition, the CMA is now the lead enforcer under the Unfair Terms in Consumer Contracts Regulations 1999.



## UK INFORMATION COMMISSIONER'S OFFICE

The UK Information Commissioner's Office is responsible for overseeing implementation of the Data Protection Act 1998. This Act regulates, among other things, the retention and use of data relating to individual customers. The Freedom of Information Act 2000 (the FOIA) sets out a scheme under which any person can obtain information held by, or on behalf of, a 'public authority' without needing to justify the request. A public authority will not be required to disclose information if certain exemptions set out in the FOIA apply.

## THE PAYMENTS SYSTEM REGULATOR (PSR)

The Payment System Regulator (PSR) is an independent economic regulator for the £75 trillion payment systems industry, which was launched back in April 2015. Payment systems form a vital part of the UK's financial system – they underpin the services that enable funds to be transferred between people and institutions. The purpose of PSR is to make payment systems work well for those that use them. The PSR is a subsidiary of the Financial Conduct Authority, but has its own statutory objectives, Managing Director and Board. In summary their objectives are: to ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them; to promote effective competition in the markets for payment systems and services - between operators, PSPs and infrastructure providers; and to promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems.

## COMPETITION REGULATION

The CMA commenced a Phase 2 competition investigation into Personal Current Account (PCA) and SME Banking in November 2014. The final CMA report was published on 9 August 2016. Findings and proposed remedies were largely as expected and consistent with the Interim publication. Key remedies include: introduction of 'Open Banking', publication of service quality information and customer information prompts. Recommendations were also made regarding improvements to Current Account switching, monthly maximum charge for PCA overdraft users, overdraft notifications and additional measures for small business to make comparison easier.

The FCA obtained concurrent competition powers on 1 April 2015 in relation to the provision of financial services in the UK, in addition to its already existing competition objective. The FCA has been undertaking a programme of work to assess markets across financial services to ascertain whether or not competition is working effectively in the best interests of consumers. The FCA announced on 3 November 2016 that it will take action to improve

## REGULATION

competition in the current account market, following the CMA's recommendations. The FCA actions will extend beyond the CMA remedies and will include considering whether rules are required in relation to the maximum monthly charge for overdrafts plus taking forward further work on overdrafts through its work on high cost credit. The FCA will also act as an observer on the Open Banking steering group and be involved in developing and testing "prompts" to encourage customers to consider their banking arrangements.

The Payment Systems Regulator (PSR) became operational in April 2015 with concurrent competition powers in respect of UK payment systems, in addition to a statutory objective to promote effective competition. The PSR has completed two market reviews into the provision of indirect access and into the ownership and competitiveness of payments infrastructure. The final report for indirect access was published in July noting some concerns with quality of access, limited choice and barriers to switching. The final report for competitiveness of payments infrastructure, also published in July, noted some concerns with competition in payments infrastructure.

In addition, the PRA also has a secondary objective under the Financial Services (Banking Reform) Act to, so far as reasonably possible, act in a way which facilitates effective competition.

The UK government has a continuing interest in competition. In November 2015, the Government published a document entitled "A better deal: boosting competition to bring down bills for families and firms". This document focuses on the competition aspects of the government's productivity plan and aims to promote competition in various sectors, including financial services.

The new regulatory regime may lead to greater UK Government and regulatory scrutiny or intervention in the future, ranging from enforced product and service developments and payment system changes to significant structural changes. This could have a significant effect on the Group's operations, financial condition or the business of the Group.

## EU REGULATION

A High Level Expert Group, chaired by Erkki Liikanen (the 'Liikanen Report'), considered whether there is a need for structural reforms of the EU banking sector and to make relevant proposals as appropriate, with the objective of establishing a stable and efficient banking system serving the needs of citizens, the economy and the internal market. The High Level Expert Group presented its recommendations to the EU Commissioner on 2 October 2012. They recommended a set of five measures that augment and complement the set of regulatory reforms already enacted or proposed by the EU, the Basel Committee and national governments. First, proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant

share of the bank's business. This would ensure that trading activities beyond the threshold are carried out on a stand-alone basis and separate from the deposit bank. The other measures include: emphasising the need for banks to draw up and maintain effective and realistic recovery and resolution plans; supporting the use of designated bail out instruments; applying more robust weights in the determination of minimum capital standards; and augmenting existing corporate governance reforms such as strengthening boards and management, promoting the risk management function, rein in compensation for bank management and staff, improve risk disclosure, and strengthening sanctioning powers.

On 17 January 2014, the EU Commission published a press release confirming that it intends to make a proposal for the reform of the structure of banking in the EU, which will be based on the Liikanen Report. The objective of the reforms will be to make the financial sector as a whole more robust and resilient, to reduce the impact of potential bank failures, and ensure the financial sector is at the service of the real economy. In doing so, the reforms will aim to eliminate the concept of banks being 'too big to fail.' The proposed regulation included derogation from the separate requirements for banks in member states which had implement equivalent legislation before 29 January 2014 (including the UK). The form of the proposed EU regulation has been subject to much debate within the European institutions, with uncertainty surrounding both the outcome and timeline for conclusion. The main disagreements concern the need for 'automatic' separation of trading activities and the level of discretion given to National Competent Authorities.

The UK is subject to the directives introduced under the Financial Services Action Plan. However, these directives are regularly reviewed at EU level and could be subject to change. The Group will continue to monitor the progress of these initiatives, provide specialist input on their drafting and assess the likely impact on its business.

CRD IV implements the Basel III agreement in the EU, and introduces significant changes in the prudential regulatory regime applicable to banks including: increased minimum capital ratios; changes to the definition of capital and the calculation of risk-weighted assets; and the introduction of new measures relating to leverage, liquidity and funding. CRD IV also makes changes to rules on corporate governance, including remuneration, and introduces standardised EU regulatory reporting requirements which will specify the information that must be reported to supervisors in areas such as own funds, large exposures and financial information.

On 29 January 2014 the European Commission published its long-awaited proposals for structural reform of EU banks in the form of a draft regulation. The proposals apply to the largest EU banks and groups – on the basis of historical data the Commission estimates that 29 EU banks may be subject to such proposed regulation. The Commission's publication is only a proposal at this stage. It may well be amended, perhaps substantially, by the European Parliament and the Council before it is adopted.

## **US REGULATION**

In the United States, Lloyds Bank plc maintains a branch in New York, licensed by the New York State Department of Financial Services (NYDFS) and subject to regulation and examination by the NYDFS and the Federal Reserve Bank of New York (FRBNY). Bank of Scotland plc maintains a branch in New York (also licensed by the NYDFS and subject to regulation and examination by the NYDFS and the FRBNY) and maintains a representative office in Houston, licensed by the State of Texas and subject to regulation and examination by the banking supervisors of the State of Texas and the Federal Reserve Bank of Dallas. A former representative office which Bank of Scotland plc maintained in Chicago was closed and its license surrendered to the Division of Banking of the State of Illinois as of 31 August 2016.

The licensing authority of each US branch has the authority, in certain circumstances, to take possession of the business and property of Lloyds Bank plc and Bank of Scotland plc located in the state of the office it licenses. Such circumstances generally include violations of law, unsafe business practices and insolvency.

The existence of branches in the US subjects Lloyds Banking Group plc and its subsidiaries doing business or conducting activities in the US to oversight by the Board of Governors of the Federal Reserve System (Federal Reserve Board).

Each of Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and Bank of Scotland plc is a foreign banking organisation treated as a bank holding company within the meaning of the US Bank Holding Company Act of 1956 (BHC Act) in accordance with the provisions of the International Banking Act of 1978 and each has elected, with the permission of the Federal Reserve Board, to be treated as a financial holding company under the BHC Act.

## REGULATION

Financial holding companies may engage in a broader range of financial and related activities than are permitted to bank holding companies that do not maintain financial holding company status, including underwriting and dealing in all types of securities. To maintain financial holding company status, Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and Bank of Scotland plc are required to meet certain capital ratios and be deemed to be 'well managed' for purposes of the Federal Reserve Board's regulations. The Group's direct and indirect activities and investments in the United States are limited to those that are 'financial in nature' or 'incidental' or 'complementary' to a financial activity, as determined by the Federal Reserve Board.

The Group is also required to obtain the prior approval of the Federal Reserve Board before acquiring, directly or indirectly, the ownership or control of more than 5 per cent of any class of the voting shares of any US bank or bank holding company.

The Group's US broker dealer, Lloyds Securities Inc. is subject to regulation and supervision by the US Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority with respect to its securities activities, including sales methods, trade practices, use of safekeeping of customers' funds and securities, capital structure, recordkeeping, the financing of customers' purchases and conduct of directors, officers and employees.

A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with US economic sanctions, with serious legal and reputational consequences for any failures arising in these areas. The Group engages, or has engaged, in a limited amount of business with counterparties in certain countries which the US State Department currently designates as state sponsors of terrorism, including Iran, Syria and Sudan. The Group intends to engage only in new business in such jurisdictions and only in very limited circumstances where the Group is satisfied concerning legal, compliance and reputational issues. At 31 December 2016, the Group does not believe that the Group's business activities relating to countries designated as state sponsors of terrorism were material to its overall business.

The Group estimates that the value of the Group's business in respect of such states represented less than 0.01 per cent of the Group's total assets and, for the year ended December 2016, the Group believes that the Group's revenues from all activities relating to such states were less than 0.001 per cent of its total income, net of insurance claims. This information has been compiled from various sources within the Group, including information manually collected from relevant business units, and this has necessarily involved some degree of estimate and judgement.

## DODD-FRANK ACT

In July 2010, the United States enacted the Dodd-Frank Act, which provides a broad framework for significant regulatory changes that extend to almost every area of US financial regulation. The Dodd-Frank Act addresses, among other issues, systemic risk oversight, bank capital standards, the resolution of failing systemically significant financial institutions in the US, over the counter derivatives, restrictions on the ability of banking entities to engage in proprietary trading activities and make investments in and sponsor certain private equity funds and hedge funds (known as the ‘Volcker Rule’), asset securitisation activities and securities market conduct and oversight. US regulators have implemented many provisions of the Dodd-Frank Act through detailed rulemaking. Although most of the rules and regulations are now in force, it is unclear how they will be interpreted in practice by the supervisors.

Under the Dodd-Frank Act, entities that are swap dealers and major swap participants must register with the US Commodity Futures Trading Commission (CFTC), and entities that are security-based swap dealers or major security based swap participants will be required to register with the SEC. The CFTC has promulgated its registration rules for swap dealers and major swap participants. The SEC finalised its registration rules for security-based swap dealers and major security-based swap participants; however, the registration requirement will not be effective until certain other regulations applicable to security-based swap dealers are adopted. Lloyds Bank plc provisionally registered as a swap dealer in 2013 and as such, is subject to regulation and supervision by the CFTC and the National Futures Association with respect to its swap activities, including risk management, practices, trade documentation and reporting, business conduct and recordkeeping, among others.

The New York branch of Lloyds Bank plc is subject to the swap ‘push-out’ provisions of the Dodd-Frank Act, which will require monitoring to ensure the Group conducts its derivatives activities in conformity with the implementing regulations. In December 2014, the swap “push out” provisions of the Dodd-Frank Act were amended such that fewer swap activities need to be pushed out of covered depository institutions.

Furthermore, the Dodd-Frank Act requires the SEC to cause issuers with listed securities, which may include foreign private issuers such as the Group, to establish a ‘clawback’ policy to recoup previously awarded employee compensation in the event of an accounting restatement. The SEC has proposed implementing regulations which have not yet been finalised. The Dodd-Frank Act also grants the SEC discretionary rule-making authority to impose a new fiduciary standard on brokers, dealers and investment advisers, and expands the extraterritorial jurisdiction of US courts over actions brought by the SEC or the United States with respect to violations of the antifraud provisions of the United States Securities Act of 1933, as amended (the “Securities Act”), the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.

In December 2013, US regulators adopted final rules implementing the Volcker Rule. Banking entities, including foreign banking organisations subject to the BHC Act, such as Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and Bank of Scotland plc, are subject to the final rules which require banking entities to conform to the restrictions on proprietary trading activities, hedge fund and private equity activities and certain other enumerated investment restrictions, subject to a number of exclusions and exemptions that substantially limit their extraterritorial reach. Certain foreign banking entities are permitted to engage in proprietary trading from outside the United States if the trade lacks the requisite US nexus and the foreign banking entity complies with the various conditions of the exemption. Investments in, and sponsorship of certain retail investment funds organised outside the United States and publicly offered predominantly outside the United States, and certain retirement and pension funds organised and administered outside the United States for the benefit of non-US residents are generally permitted under the final

rules. Certain foreign banking entities, but not any US branch, agency or subsidiary of a foreign banking entity, nor any non-US affiliate controlled by such a US branch, agency or subsidiary, are also permitted to invest in and sponsor certain funds in which ownership interests are not offered for sale or sold inside the United States or to US residents and subject to other conditions. The final rules impose significant compliance and reporting obligations on banking entities. Banking entities had until 21 July 2015 to bring their activities and investments into conformity with the Volcker Rule, however, on 18 December 2014, the Federal Reserve issued an order extending the Volcker Rule's conformance period until 21 July 2016 for investments in and relationships with certain covered funds and certain foreign funds that were in place on or prior to 31 December 2013. On July 7, 2016, the Federal Reserve announced a final one-year extension of the general conformance period for banking entities to conform ownership interests in and relationships with legacy covered funds to July 21, 2017. On December 12, 2016, the Federal Reserve issued a policy statement with information about how banking entities may seek a statutory extension of the conformance period of five years for certain legacy covered funds that are also illiquid funds.

In February 2014, pursuant to the Dodd-Frank Act's systemic risk regulation provisions, the Federal Reserve Board adopted final rules that apply enhanced prudential standards to the US operations of large foreign banking organisations, including the Group. Under the Federal Reserve Board's final rules, a number of large foreign banking organisations were required by July 1, 2016 to establish a separately capitalised top-tier US intermediate holding company (IHC) to hold all of the large foreign banking organisation's US bank and non-bank subsidiaries, except its US branches and agencies

## REGULATION

and specified types of subsidiaries. However, this requirement does not apply to a large foreign banking organisation with combined US assets of less than \$50 billion, excluding assets held by its US branches and agencies. This requirement does not apply to the Group. In addition, under the final rules, as of 1 July 2016, US branches and agencies of foreign banking organisations with \$50 billion or more in total global consolidated assets, such as the Group, are subject to liquidity home country capital certification and, in certain circumstances, asset maintenance requirements. These foreign banking organisations are also required to maintain a US Risk Committee as of 1 July 2016. However, final rules for single counterparty credit limits and for early remediation have yet to be finalised.

The Dodd-Frank Act and related rules and regulations will result in additional costs and impose certain limitations and restrictions on the way that the Group conducts its business, although uncertainty remains about some of the final details, impact and timing of the implementing regulations.

## **DISCLOSURE PURSUANT TO SECTION 219 OF THE IRAN THREAT REDUCTION AND SYRIA HUMAN RIGHTS ACT (ITRA)**

Since the introduction of an enhanced financial sanctions policy, the Group has been proactive in reducing its dealings with Iran and individuals and entities associated with Iran. There remain a small number of historic Iran-related business activities which the Group has not yet been able to terminate for legal or contractual reasons.

Pursuant to ITRA Section 219, the Group notes that during 2016, its non-US affiliates, Lloyds Bank plc and Bank of Scotland plc, received or made payments involving entities owned or controlled by the Government of Iran as defined under section 560.304 of title 31, Code of Federal Regulations, and/or designated under Executive Order 13382. In all cases, the payment was permitted under UK and EU sanctions legislation, specific authority was sought from and granted by HM Treasury, the UK's Competent Authority to provide such authorisations or the payment(s) were credited to a blocked account, held in the name of the entity, in accordance with UK and EC sanctions legislation.

Gross revenues from these activities were approximately £6,000. Net profits from these activities were approximately £10,000.

The Group's businesses, being reported below, are conducted in compliance with applicable laws in respect of Iran sanctions and, except as noted below, the Group intends to continue these historic activities until it is able to legally terminate the contractual relationships or maintain/manage in accordance with prevailing sanctions obligations. The nature of these activities is as follows:



Edgar Filing: Lloyds Banking Group plc - Form 20-F

Receipts in relation to partial repayments of a European Export Credit Agreement loan made prior to 2005 with  
1. respect to engineering and the supply of equipment and related services for several projects in Iran. The loan remains outstanding. The borrower and/or guarantor is owned by the Government of Iran.

Payments made to Building and Housing Research Centre in Iran related to a guarantee, entered into by the Group  
2. in 2006, in connection with the supply of seismic equipment for free field accelerometers systems for dams and civil building monitoring. The beneficiary of the guarantee is an entity owned by the Government of Iran and the payments were made to a frozen account in a European bank for an entity designated under Executive Order 13382.

Payments received relating to operational and processing costs for a joint venture between BP Exploration Company  
3. Limited and Iranian Oil Company (UK) Limited. The Iranian Oil Company (UK) Limited is designated under Executive Order 13599). These payments are permitted under OFAC license IA-2013-302799-5.

Payments made to a blocked account in the name of Commercial Bank of Syria related to historic guarantees,  
4. entered into by the Group between 1997 and 2008, the majority of which relate to Bail Bonds for vessels. The Commercial Bank of Syria is designated under Executive order 13382.

Sums paid out from a pension trust fund to UK nationals resident in the UK who were employees of a company  
5. indirectly owned or controlled by an entity designated under Executive Order 13382 that is also owned or controlled by the Government of Iran.

Lloyds continues to provide payment clearing services to a UK based and UK authorised bank, one of whose  
account holders is an entity designated under Executive Order 13224 (although not by the UK or EU authorities).  
Lloyds concludes from the nature of such payment clearing services that revenue and profit (if any) arising from  
6. indirectly providing such services to the designated entity is negligible and not material to the Group's activities and in any event does not flow directly from the designated entity. To the extent that the activities of the designated entity and its UK authorised bank continue to comply with UK regulation and legislation, Lloyds intends to keep this activity under review.

## LISTING INFORMATION

The ordinary shares of Lloyds Banking Group plc are listed and traded on the London Stock Exchange under the symbol 'LLOY.L'. The prices for shares as quoted in the official list of the London Stock Exchange are in pounds sterling. The following table shows the reported high and low closing prices for the ordinary shares on the London Stock Exchange. This information has been extracted from publicly available documents from various sources, including officially prepared materials from the London Stock Exchange, and has not been prepared or independently verified by the Lloyds Banking Group.

	Price per share (in pence) High	Price per share (in pence) Low
Annual prices:		
2016	73.74	47.55
2015	89.00	68.68
2014	86.30	70.94
2013	80.37	46.31
2012	49.25	25.30
Quarterly prices:		
2016		
Fourth quarter	64.37	52.38
Third quarter	60.95	47.55
Second quarter	73.74	51.15
First quarter	73.27	56.00
2015		
Fourth quarter	77.83	68.68
Third quarter	87.65	72.30
Second quarter	89.00	77.38
First quarter	81.43	72.87
2014		
Fourth quarter	80.89	72.27
Third quarter	76.87	71.92
Second quarter	80.15	70.94
First quarter	86.30	74.34
Monthly prices:		
January 2017	66.58	64.20
December 2016	64.37	57.55
November 2016	61.40	55.15
October 2016	57.74	52.38
September 2016	60.95	54.25
August 2016	59.35	51.95

On 24 February 2017, the closing price of shares on the London Stock Exchange was 69.28 pence, equivalent to 86.59 US cents per share translated at the Noon Buying Rate of \$1.2499 per £1.00 on 24 February 2017.

Lloyds Banking Group plc's American Depositary Receipts (ADRs) were traded on the over-the-counter market in the US under the symbol 'LLDTY' between March 2000 and November 2001. Since 27 November 2001 Lloyds Banking Group plc American Depositary Shares (ADSs) have been listed on the New York Stock Exchange under the symbol 'LYG'. Each ADS represents four ordinary shares.

## LISTING INFORMATION

The following table shows the reported high and low closing prices for ADSs on the New York Stock Exchange.

	Price per ADS (in US dollars)	Price per ADS (in US dollars)
	High	Low
Annual prices:		
2016	4.40	2.55
2015	5.64	4.25
2014	5.76	4.62
2013	5.36	2.84
2012	3.23	1.53
Quarterly prices:		
2016		
Fourth quarter	3.21	2.61
Third quarter	3.31	2.55
Second quarter	4.40	2.78
First quarter	4.32	3.32
2015		
Fourth quarter	4.83	4.25
Third quarter	5.53	4.47
Second quarter	5.64	4.65
First quarter	4.96	4.38
2014		
Fourth quarter	5.02	4.62
Third quarter	5.32	4.70
Second quarter	5.53	4.83
First quarter	5.76	5.01
2013		
Fourth quarter	5.36	4.67
Third quarter	5.00	3.83
Second quarter	3.91	2.84
First quarter	3.58	2.89
2012		
Fourth quarter	3.23	2.34
Third quarter	2.56	1.75
Second quarter	2.12	1.53
First quarter	2.35	1.58
Monthly prices:		
January 2017	3.38	3.21
December 2016	3.21	2.91
November 2016	3.12	2.75
October 2016	2.84	2.61
September 2016	3.31	2.87

August 2016	3.21	2.81
-------------	------	------

On 24 February 2017, the closing price of ADSs on the New York Stock Exchange was \$3.50.

183

LISTING INFORMATION

**ADR FEES**

The Group's depository, The Bank of New York Mellon, collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depository collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depository may collect its annual fee for depository services by deductions from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depository may generally refuse to provide fee-attracting services until its fees for those services are paid.

Persons depositing or withdrawing shares must pay:

\$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)

\$.02 (or less) per ADS

A fee equivalent to the fee that would be payable if securities distributed had been shares and the shares had been deposited for issuance of ADSs

\$.02 (or less) per ADSs per calendar year

Registration or transfer fees

Expenses of the depository

Taxes and other governmental charges the depository or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes

Any charges incurred by the depository or its agents for servicing the deposited securities

For:

Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property.

Cancellation of ADSs for the purpose of withdrawal, including if the deposit agreement terminates.

Any cash distribution to ADS registered holders.

Distribution of securities distributed to holders of deposited securities which are distributed by the depository to ADS registered holders.

Depository services.

Transfer and registration of shares on the share register to or from the name of the depository or its agent when you deposit or withdraw shares.

Cable, telex and facsimile transmissions (when expressly provided in the deposit agreement).

Converting foreign currency to US dollars.

As necessary.

As necessary.

*FEES RECEIVED TO DATE*

In 2016, the Company received from the depository \$842,755 for continuing annual stock exchange listing fees, standard out-of-pocket maintenance costs for the ADRs (consisting of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of US Federal

tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls), any applicable performance indicators relating to the ADR facility, underwriting fees and legal fees.

*FEES TO BE PAID IN THE FUTURE*

The Bank of New York Mellon, as depositary, has agreed to reimburse the Company for maintenance expenses that they incur for the ADS program. The depositary has agreed to reimburse the Company for its continuing annual stock exchange listing fees. The depositary has also agreed to pay the standard out-of-pocket maintenance costs for the ADRs, which consist of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of US Federal tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls. It has also agreed to reimburse the Company annually for certain investor relationship programs or special investor relations promotional activities. In certain instances, the depositary has agreed to provide additional payments to the Company based on any applicable performance indicators relating to the ADR facility. There are limits on the amount of expenses for which the depositary will reimburse the Company, but the amount of reimbursement available to the Company is not necessarily tied to the amount of fees the depositary collects from investors.

## DIVIDENDS

Lloyds Banking Group plc's ability to pay dividends is restricted under UK company law. Dividends may only be paid if distributable profits are available for that purpose. In the case of a public limited company, a dividend may only be paid if the amount of net assets is not less than the aggregate of the called-up share capital and undistributable reserves and if the payment of the dividend will not reduce the amount of the net assets to less than that aggregate. In addition, a company cannot pay a dividend if any of its UK insurance subsidiaries is insolvent on a regulatory valuation basis or, in the case of regulated entities, if the payment of a dividend results in regulatory capital requirements not being met. Similar restrictions exist over the ability of Lloyds Banking Group plc's subsidiary companies to pay dividends to their immediate parent companies. Furthermore, in the case of Lloyds Banking Group plc, dividends may only be paid if sufficient distributable profits are available for distributions due in the financial year on certain preferred securities. The board has the discretion to decide whether to pay a dividend and the amount of any dividend. In making this decision, the board is mindful of the level of dividend cover and, consequently, profit growth may not necessarily result in increases in the dividend. In the case of American Depositary Shares, dividends are paid through The Bank of New York Mellon which acts as paying and transfer agent.

The total ordinary dividend for 2016 of 2.55 pence per share has increased from 2.25 pence per share in 2015, in line with the Group's progressive and sustainable ordinary dividend policy, and the Group continues to expect ordinary dividends to increase over the medium term with a dividend payout ratio of at least 50 per cent of sustainable earnings.

At the time of proposal, the special dividend of 0.5 pence per share (2015: 0.5 pence per share) represented the distribution of capital over and above the Board's view of the current level of CET1 capital required to grow the business, meet regulatory requirements and cover uncertainties, and allowed for the estimated capital impact of the MBNA acquisition. Subsequently, on 2 March 2017, the FCA provided further clarification in relation to the consultation paper dealing with PPI, resulting in an additional provision of £350 million being recorded, reducing the adjusted CET1 ratio by c.20bps.

The Board's view of the current level of CET1 capital required to grow the business, meet regulatory requirements and cover uncertainties remains unchanged at 13 per cent but this level may vary from time to time depending on circumstances and the Board will give due consideration, subject to the situation at the time, to the distribution of any surplus capital through the use of special dividends or share buy backs.

The table below sets out the interim and final dividends in respect of the ordinary shares for fiscal years 2004 through 2016. The sterling amounts have been converted into US dollars at the Noon Buying Rate in effect on each payment date with the exception of the recommended final dividend for 2016, for which the sterling amount has been converted in US dollars at the Noon Buying Rate on 24 February 2017.

Interim ordinary   Interim ordinary   Final ordinary   Final ordinary



Edgar Filing: Lloyds Banking Group plc - Form 20-F

	dividend per share (pence)	dividend per share (cents)	dividend per share (pence)	dividend per share (cents)
2004	10.7	19.0	23.5	44.7
2005	10.7	18.9	23.5	43.3
2006	10.7	20.2	23.5	46.8
2007	11.2	22.8	24.7	48.2
2008	11.4	20.3	–	–
2009	–	–	–	–
2010	–	–	–	–
2011	–	–	–	–
2012	–	–	–	–
2013	–	–	–	–
2014 <sup>1</sup>	–	–	0.75	1.16
2015 <sup>2</sup>	0.75	1.14	1.5	2.17
<b>2016<sup>3</sup></b>	<b>0.85</b>	<b>1.10</b>	<b>1.70</b>	<b>2.12</b>

<sup>1</sup>The recommended dividend for 2014 was in respect of the full year.

<sup>2</sup>For 2015, the Board also made a capital distribution in the form of a special dividend of 0.5 pence per share (0.72 cents per share). This is not listed in the table above.

<sup>3</sup>The Board has also recommended a capital distribution in the form of a special dividend of 0.5 pence per share (0.62 cents per share at the Noon Buying Rate on 24 February 2017) for 2016. This is not listed in the table above.

185

## ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

Lloyds Banking Group plc is incorporated in Scotland under the UK Companies Act 1985 with registered number SC95000.

As resolved at the 2016 Annual General Meeting, with effect from 12 May 2016, Lloyds Banking Group plc amended its Articles of Association to: (i) remove the power for Lloyds Banking Group plc to issue share warrants to bearer, in accordance with legislative changes made to the Companies Act in 2015 as a result of the introduction of the UK Small Business, Enterprise and Employment Act 2015; (ii) amend the process to be adopted by Lloyds Banking Group plc in relation to untraceable shareholders and unclaimed dividends to reflect developing practice; and (iii) provide a limit on the aggregate amount of ordinary remuneration that may be paid to the directors.

A summary of the material provisions of Lloyds Banking Group plc's Articles of Association is set out below.

## OBJECTS OF LLOYDS BANKING GROUP PLC

The objects of Lloyds Banking Group plc are unrestricted.

## RIGHTS ATTACHING TO SHARES

Any share in Lloyds Banking Group plc may be issued with any preferred, deferred or other special rights (including being denominated in another currency), or subject to such restrictions (whether as regards dividend, returns of capital, voting or otherwise) as Lloyds Banking Group plc may from time to time determine by ordinary resolution or as otherwise provided in the Articles of Association.

Subject to statute, Lloyds Banking Group plc may issue any shares which are, or at Lloyds Banking Group plc's option are, liable to be redeemed. The directors may determine the terms and conditions and manner of such redemption.

## VOTING RIGHTS

For the purposes of determining which persons are entitled to attend or vote at a meeting and how many votes such persons may cast, Lloyds Banking Group plc may specify in the notice of the meeting a time, not more than 48 hours before the time fixed for the meeting, by which a person must be entered on the register in order to have the right to attend or vote at the meeting.

Every holder of ordinary shares who is entitled to be and is present in person (including any corporation by its duly authorised representative) at a general meeting of Lloyds Banking Group plc and is entitled to vote will have one vote on a show of hands and, on a poll, if present in person or by proxy, will have one vote for every such share held by him, save that a member will not be entitled to exercise the right to vote carried by such shares if he or any person appearing to be interested in the shares held by him has been duly served with a notice under the Companies Act (requiring disclosure of interests in shares) and is in default in supplying Lloyds Banking Group plc with information required by such notice.

The limited voting shares confer the right to receive notice of and to attend and speak at all general meetings of Lloyds Banking Group plc, but do not confer a right to vote unless the business of the meeting includes the consideration of a resolution:

- for the winding-up of Lloyds Banking Group plc; or
- to vary, modify or abrogate any of the rights attaching to the limited voting shares.

In any such case, the holder may vote the limited voting shares only in respect of such resolution and will have the same rights with regard to the number and exercise of votes as a holder of ordinary shares but, in the case of a variation in the rights of limited voting shares, shall also have the protection of a requirement for approval of the variation either by way of consent in writing by the holders of three-quarters in nominal value of the issued limited voting shares or by a special resolution at a separate class meeting of the holders of limited voting shares.

Preference shares confer such rights as may be determined by the directors on allotment, but unless the directors otherwise determine, fully paid preference shares confer identical rights as to voting, capital, dividends (save as to currency or payment thereof) and otherwise, notwithstanding that they are denominated in different currencies and shall be treated as if they are one single class of shares. There are no limitations imposed by UK law or the Articles of Association restricting the rights of non-residents of the UK or non-citizens of the UK to hold or vote shares of Lloyds Banking Group plc.

## **GENERAL MEETINGS**

Annual general meetings of Lloyds Banking Group plc are to be held, in each period of six months beginning with the day following Lloyds Banking Group plc's accounting reference date, in Edinburgh or such other place in Scotland as the directors shall appoint and at a date and time as may be determined by the directors. All other general meetings may be convened whenever the directors think fit and shall be requisitioned in accordance with the requirements of the Articles of Association.

Lloyds Banking Group plc must prepare a notice of meeting in respect of a general meeting in accordance with the requirements of the Articles of Association and the Companies Act. Lloyds Banking Group plc must give at least 21 clear days' notice in writing of an annual general meeting. All other general meetings may be called by at least 14 clear days' notice in writing.

The directors may make arrangements to enable attendance or regulate the level of attendance at any place specified in the notice of meeting for the holding of a general meeting and, in any such case, shall direct that the meeting be held at a specified place, where the chairman of the meeting shall preside, and make arrangements for simultaneous attendance and participation by members and proxies at other locations. The chairman of a general meeting has express authority to adjourn the meeting if, in his opinion, it appears impracticable to hold or continue the meeting because of crowding or unruly conduct or because an adjournment is otherwise necessary for the proper conduct of the meeting.

The processes and procedures for the conduct of a general meeting (including adjourning meetings, voting, amending resolutions and appointing proxies) is established under the Articles of Association and the Companies Act. The chairman of a general meeting shall be entitled to take any action he considers appropriate for properly and orderly conduct before and during a general meeting. The directors shall be entitled to ask persons wanting to attend to submit to searches or other security arrangements as such directors consider appropriate.

The quorum necessary for the transaction of business at a general meeting is three members present in person or by proxy and entitled to vote.

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

**DIVIDENDS AND OTHER DISTRIBUTIONS AND RETURN OF CAPITAL**

Under the Companies Act, before Lloyds Banking Group plc can lawfully make a distribution, it must ensure that it has sufficient distributable reserves (accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made). Under the Articles of Association (and subject to statute) the directors are entitled to set aside out of the profits of Lloyds Banking Group plc any sums as they think proper which, at their discretion, shall be applicable for any purpose to which the profits of Lloyds Banking Group plc may be applied.

The shareholders in general meeting may by ordinary resolution declare dividends to be paid to members of Lloyds Banking Group plc, but no dividends shall be declared in excess of the amount recommended by the directors. The directors may pay fixed dividends on any class of shares carrying a fixed dividend and may also from time to time pay dividends, interim or otherwise, on shares of any class as they think fit. Except in so far as the rights attaching to any shares otherwise provide, all dividends shall be apportioned and paid pro rata according to the amounts paid up thereon. Subject to the rights attaching to any shares, any dividend or other monies payable in respect of a share may be paid in such currency or currencies as the directors may determine using such exchange rates as the directors may select.

The opportunity to elect to receive new shares instead of any cash dividend recommended by the directors may be offered to shareholders provided that the directors shall have obtained in advance the shareholders' approval to do so as required by the Articles of Association and the procedure under the Articles of Association is followed for allotting such shares.

In addition, Lloyds Banking Group plc may by ordinary resolution direct the payment of a dividend in whole or in part by the distribution of specific assets (a distribution *in specie*).

The limited voting shares do not confer a right to participate in any distribution of profits by way of dividend. For any other distributions, the limited voting shares shall be deemed to confer rights and interests in the profits equally with the holders of ordinary shares according to the amounts paid up on such limited voting shares and ordinary shares respectively otherwise than in advance of calls.

On any distribution by way of capitalisation, the amount to be distributed will be appropriated amongst the holders of ordinary shares and limited voting shares in proportion to their holdings of ordinary shares and limited voting shares (pro rata to the amount paid up thereon). If the amount to be distributed is applied in paying up in full unissued ordinary shares and limited voting shares of Lloyds Banking Group plc, a shareholder will be entitled to receive bonus

shares of the same class as the shares giving rise to his entitlement to participate in the capitalisation.

Any dividend or other moneys payable to a member that has not been cashed or claimed after a period of 12 years from the date of declaration of such dividend or other moneys payable to a member will be forfeited and revert to Lloyds Banking Group plc. Lloyds Banking Group plc shall be entitled to use such unclaimed or unclaimed dividend or other moneys payable to a member for its benefit in any manner that the directors may think fit.

Lloyds Banking Group plc shall not be a trustee of dividends or other moneys payable that have not been cashed or claimed and it shall not be liable to pay interest on such dividends or other moneys.

On a return of capital, whether in a winding-up or otherwise, the ordinary shares and the limited voting shares will rank equally in all respects and the preference shares will be entitled to the rights attaching to them on issue.

Lloyds Banking Group plc's ordinary shares and limited voting shares do not confer any rights of redemption. Rights of redemption in respect of Lloyds Bank Group plc's preference shares shall be as the directors determine on allotment.

Lloyds Banking Group plc may, subject to applicable law and to the Articles of Association, issue redeemable shares and redeem the same. Lloyds Banking Group plc has issued certain preference shares which are redeemable. In general, subject to applicable law and the approval of the UK Prudential Regulation Authority, some of these shares are redeemable by Lloyds Banking Group plc on a specified date and in some cases, thereafter on relevant dividend payment dates. Others are redeemable at any time during a specified period and following the occurrence of specified regulatory events.

Under the Articles of Association and the Companies Act, the liability of shareholders is limited to the amount (if any) for the time being unpaid on the shares held by that shareholder.

## **CONVERSION OF LIMITED VOTING SHARES**

Each limited voting share will be converted into an ordinary share:

on the day following the last date on which an amount could become due and payable to a holder of limited voting shares under a deed of covenant. A deed of covenant is a legal document which records the obligation of one person to pay a specified sum to another for a specified number of years; or

if an offer is made to ordinary shareholders (or to all such shareholders other than the offeror and/or any body corporate controlled by the offeror and/or any persons acting in concert with the offeror) to acquire the whole or any

part of the issued ordinary share capital of Lloyds Banking Group plc and the right to cast more than 50 per cent of the votes which may ordinarily be cast on a poll at a general meeting of Lloyds Banking Group plc becomes or is certain to become vested in the offeror and/or any bodies corporate controlled by the offeror and/or any persons acting in concert with the offeror. Once the directors become aware of such vesting, they must serve a written notice on all holders of limited voting shares stating that such event has occurred. The publication of a scheme of arrangement under the statutes providing for the acquisition by any person of the whole or part of the ordinary share capital of Lloyds Banking Group plc shall be deemed to be the making of an offer for this purpose.

The ordinary shares resulting from conversion will carry the right to receive all dividends and other distributions declared, made or paid on the ordinary share capital of Lloyds Banking Group plc by reference to a record date on or after the date of conversion and will rank equally in all other respects and form one class with the ordinary share capital of Lloyds Banking Group plc then in issue and fully paid.

While the limited voting shares remain unconverted, their holders will be entitled to participate in any offer made to subscribe for or purchase any securities of Lloyds Banking Group plc (or any other company) as if the limited voting shares had been converted at the relevant record date of such offer.

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

**VARIATION OF RIGHTS AND ALTERATION OF CAPITAL**

Subject to the provisions of the Companies Act, the CREST Regulations and every other statute for the time being in force or any judgment or order of any court of competent jurisdiction concerning companies and affecting Lloyds Banking Group plc (the statutes), the rights attached to any class of shares for the time being in issue may (subject to their terms of issue) be varied or abrogated with the consent in writing of the holders of not less than three-quarters in nominal value of the issued shares of that class or with the sanction of a special resolution passed at a separate meeting of the holders of shares of that class. At any such separate meeting, the provisions of the Articles of Association relating to general meetings will apply, but the necessary quorum at any such meeting will be two persons holding or representing by proxy at least one-third in nominal value of the issued shares of that class (except at an adjourned meeting, at which the quorum shall be any holder of shares of the class, present in person or by proxy) and any such person may demand a poll and every such holder shall on a poll have one vote for every share of the class held by such holder.

Any special rights attached to any class of shares having preferential rights will not be deemed to be varied by: (i) the creation or issue of further shares ranking in some or all respects equally to such class (but not in priority thereto); or (ii) the creation or redemption by Lloyds Banking Group plc of its own shares.

However, for so long as the limited voting shares have not been converted (as described above):

Lloyds Banking Group plc is prohibited from consolidating or subdividing any of the ordinary shares without consolidating or subdividing the limited voting shares in a like manner and to a like extent; and

Lloyds Banking Group plc will not create any new class of equity share capital, other than in connection with or pursuant to an employees' share scheme approved by Lloyds Banking Group plc in general meeting, provided that the creation of equity share capital which carries (as compared with the existing ordinary shares) only restricted voting or no voting rights and no greater rights as regards dividends or capital shall not be deemed to be the creation of a new class of equity share capital. Lloyds Banking Group plc will not alter the rights attached to all or any part of its share capital or attach any special rights or privileges or restrictions thereto.

As a matter of UK law, Lloyds Banking Group plc may, by ordinary resolution, increase its share capital, consolidate and divide all or any of its shares into shares of larger amount, sub-divide all or any of its shares into shares of smaller amount and cancel any shares not taken or agreed to be taken by any person. Where a consolidation or subdivision of shares would result in fractions of a share, the directors may sell the shares representing the fractions for the best price reasonably obtainable, and distribute the net proceeds of such sale to the relevant members entitled to such proceeds. Where a member's entitlement to a portion of the proceeds of sale amounts to less than a minimum figure (as determined by the directors), such portion may be distributed to a charitable organisation at the directors' discretion.



Subject to the provisions of the statutes, Lloyds Banking Group plc may, by special resolution, reduce its share capital, any capital redemption reserve, share premium account or other undistributable reserve in any way.

## TRANSFER OF SHARES

All transfers of shares which are in certificated form may be effected by transfer in writing in any usual or common form or in any other form acceptable to the directors and must be executed by or on behalf of the transferor and, except in the case of fully paid shares, by or on behalf of the transferee. The transferor will be deemed to remain the holder of the shares transferred until the name of the transferee is entered in the register of members of Lloyds Banking Group plc in respect thereof. All transfers of shares which are in uncertificated form may be effected by means of a relevant system, unless the CREST Regulations provide otherwise.

The directors may, in the case of shares in certificated form, in their absolute discretion and without assigning any reason therefor, refuse to register any transfer of shares (not being fully paid shares) provided that, where any such shares are admitted to the Official List of the UK Financial Conduct Authority, such discretion may not be exercised in such a way as to prevent dealings in the shares of that class from taking place on an open and proper basis. The directors may also decline to register a transfer unless:

the instrument of transfer and the lodging of such instrument complies with the requirements of the Articles of Association and the transfer is in respect of only one class of shares; or

~~the transfer is in favour of not more than four persons as the transferee.~~

The directors shall refuse to register the transfer of any share on which Lloyds Banking Group plc has a lien and shall refuse to register the transfer of any limited voting share unless the same is:

~~between existing holders of limited voting shares; or~~

under a scheme established or order made by the Charity Commissioners or by the Court to a transferee having charitable objects; or

in the course of a winding-up to an institution having charitable objects which prohibit distributions of income and property to members to at least the same extent as is imposed on the transferor by its Memorandum of Association; or

~~at the direction of the crown to another charity having similar objects.~~

The Articles of Association otherwise contain no restrictions on the free transferability of fully paid shares.

Subject to the statutes and the rules (as defined in the CREST Regulations), and apart from any class of wholly dematerialised security, the directors may determine that any class of shares may be held in uncertificated form and that title to such shares may be transferred by means of an electronic trading system or that shares of any class should cease to be so held and so transferred.

188

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

**DISCLOSURE OF HOLDINGS EXCEEDING CERTAIN PERCENTAGES**

In broad terms, the Disclosure and Transparency Rules of the UK Financial Conduct Authority require Lloyds Banking Group plc shareholders to notify Lloyds Banking Group plc if the voting rights held by such Lloyds Banking Group plc shareholders (including by way of a certain financial instrument) reaches, exceeds or falls below three per cent, four per cent, five per cent, six per cent, seven per cent, eight per cent, nine per cent, ten per cent and each one per cent threshold thereafter up to 100 per cent. Under the Disclosure and Transparency Rules, certain voting rights in Lloyds Banking Group plc may be disregarded.

Pursuant to the Companies Act, Lloyds Banking Group plc may also send a notice to any person whom Lloyds Banking Group plc knows or has reasonable cause to believe that such person is interested in Lloyds Banking Group plc's shares or at any time during the three years immediately preceding the date on which such notice is issued to have been so interested, requiring that person to confirm whether he has or had such an interest and if so provide details of that interest as required by the notice.

Under the Articles of Association and UK law, if a person fails to comply with such a notice or provides information that is false in a material particular in respect of any shares (the default shares), the Lloyds Banking Group plc directors may serve a restriction notice on such a person. Such a restriction notice will state that the default shares and, if the Lloyds Banking Group plc directors determine, any other shares held by that person, shall not confer any right to attend or vote at any general meeting of Lloyds Banking Group plc.

In respect of a person with a 0.25 per cent or more interest in the issued shares of the class in question, the Lloyds Banking Group plc directors may direct by notice to such member that, subject to certain exceptions, no transfers of shares held by such person shall be registered and/or that any dividends or other payments on the default shares shall be retained by Lloyds Banking Group plc pending receipt by Lloyds Banking Group plc of the information requested by the Lloyds Banking Group plc directors. Certain consequences of the issue of a restriction notice are outlined above.

**MANDATORY TAKEOVER BIDS, SQUEEZE-OUT AND SELL-OUT RULES**

Other than as provided by the Companies Act and the City Code, there are no rules or provisions relating to mandatory bids and/or squeeze-out and sell-out rules in relation to the ordinary shares.

## **UNTRACED MEMBERS**

Lloyds Banking Group plc is entitled to sell, as the agent of a member, at the best price reasonably obtainable, any share registered in the name of a member (or any other person entitled to such shares at law) provided that: (i) such shares remaining untraced for 12 years and during that period at least three dividends in respect of such shares have become payable and no dividend in respect of those shares has been cashed or claimed by the relevant member; (ii) Lloyds Banking Group plc uses reasonable efforts to trace the relevant member and, following the expiry of the 12 year period, sends a notice to the last known physical or email address of such member stating Lloyds Banking Group plc's intention to sell the shares; and (iii) during the three months following sending such notice, Lloyds Banking Group plc does not receive any communication from such member. Lloyds Banking Group plc can also sell, at the best price reasonably obtainable, any additional shares held by the same member that were issued during such 12 year period provided that no dividend on such additional shares has been cashed or claimed by such member during such period.

The proceeds from the sale of untraced shares shall be forfeited by the relevant member and shall belong to Lloyds Banking Group plc. Lloyds Banking Group plc shall not be liable or be required to account to the member for the proceeds of such sale. Lloyds Banking Group plc is entitled to use or invest the proceeds from such sale in any manner that the directors think fit.

## **FORFEITURE AND LIEN**

The directors may by resolution make calls upon members in respect of any moneys unpaid on their shares (but subject to the terms of allotment of such shares) in the manner required by the Articles of Association.

If a member fails to pay in full any call or instalment of a call on or before the due date for payment, then, following notice by the directors requiring payment of the unpaid amount with any accrued interest and any expenses incurred, such share may be forfeited by a resolution of the directors to that effect (including all dividends declared in respect of the forfeited share and not actually paid before such forfeiture). A member whose shares have been forfeited will cease to be a member in respect of the shares, but will, notwithstanding the forfeiture, remain liable to pay to Lloyds Banking Group plc all monies which at the date of forfeiture were presently payable together with interest. The directors may at their absolute discretion enforce payment without any allowance for the value of the shares at the time of forfeiture or for any consideration received on their disposal or waive payment in whole or part.

Lloyds Banking Group plc has a first and paramount lien on every share (not being a fully paid share) for all monies (whether presently payable or not) called or payable at a fixed time in respect of such share, and the directors may waive any lien which has arisen and may resolve that any share shall for some limited period be exempt from such a lien, either wholly or partially.

A forfeited share becomes the property of Lloyds Banking Group plc, and it may be sold, re-allotted, otherwise disposed of or cancelled as the directors see fit. Any share on which Lloyds Banking Group plc has a lien may be sold on the terms set out in the Articles of Association. The proceeds of sale shall first be applied towards payment of the amount in respect of the lien insofar as it is still payable and then on surrender of the share certificate for cancellation (in the case of shares in certificated form), to the person entitled to the shares at the time of sale.

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

**WINDING-UP**

The directors have the power, in the name and on behalf of Lloyds Banking Group plc, to present a petition to the court for Lloyds Banking Group plc to be wound up.

If Lloyds Banking Group plc is wound up, the liquidator may, with the authority of an ordinary resolution, divide amongst the members in specie or kind the whole or any part of the assets of Lloyds Banking Group plc. The liquidator may for such purpose set such value as he deems fair upon any one or more class or classes of property and may determine how such division shall be carried out as between the members or different classes of members. The liquidator may vest any part of the assets in trustees upon such trusts for the benefit of members as the liquidator thinks fit, and the liquidation may be closed and Lloyds Banking Group plc dissolved, but so that no contributory shall be compelled to accept any shares or other property in respect of which there is a liability.

**DIRECTORS**

Subject to any other provision of the Articles of Association, the number of directors of Lloyds Banking Group plc shall be no less than seven. The minimum/maximum number of directors may be varied by ordinary resolution of Lloyds Banking Group plc. The directors may elect from them a chairman and deputy chairman (or two or more deputy chairman) and determine the period for which each is to hold office.

The business and affairs of Lloyds Banking Group plc shall be managed by the directors, who may exercise all such powers of Lloyds Banking Group plc (including its borrowing powers) as are not by the statutes or by the Articles of Association required to be exercised by Lloyds Banking Group plc in general meeting, subject to the Articles of Association, to the provisions of the statutes and to such regulations as may be set by special resolution of Lloyds Banking Group plc, but no regulation so made by Lloyds Banking Group plc will invalidate any prior act of the directors which would have been valid if such regulation had not been made.

The directors may confer upon any director holding any executive office any of the powers exercisable by them on such terms and conditions, and with such restrictions, as they think fit. The directors may also delegate any of their powers to committees. Any such committee shall have power to sub-delegate to sub-committees or to any person any of the powers delegated to it. Any such committee or sub-committee shall consist of one or more directors only. The meetings and proceedings of any such committee or sub-committee consisting of two or more persons shall be governed, with such changes as are appropriate, by the provisions of the Articles of Association regulating the meetings and proceedings of the directors. The directors may also grant powers of attorney to appoint a company, firm or person (or body of persons) to be the attorneys for Lloyds Banking Group plc with such powers, authorities and

discretions and for such period and subject to such conditions as the directors think fit.

The directors may meet to consider this business of Lloyds Banking Group plc as they think fit. Any director may summon a meeting on request. The quorum necessary for the transaction of business of the directors may be fixed from time to time by the directors and unless so fixed at any other number shall be four. Questions arising at any meeting of the directors shall be determined by a majority of votes. In the case of an equality of votes, the chairman of the meeting shall have a second or casting vote.

## **DIRECTORS' RETIREMENT**

The Articles of Association provide that a director appointed by the board either to fill a casual vacancy or as an additional director shall retire at the annual general meeting next after his appointment but shall be eligible for election as a director at that meeting. The Articles of Association further provide that each director shall retire at the annual general meeting held in the third calendar year following the year in which he was elected or last re-elected and shall be eligible for re-election as a director at that meeting. No person shall be eligible for election as a director at any general meeting unless he is a director that is retiring or is recommended by the directors for election in the manner required by the Articles of Association.

## **REMOVAL OF A DIRECTOR AND VACATION FROM OFFICE**

Subject to statute, Lloyds Banking Group plc may remove any director from office by ordinary resolution of which special notice has been given.

The office of a director will be vacated in the following circumstances:

~~the director becomes prohibited by law from acting as a director;~~

the director resigns in writing to the chairman or deputy chairman or the secretary and the directors resolve to accept such offer of resignation;

if a bankruptcy order is made against such director or such director applies to the court in connection with a voluntary arrangement under the UK Insolvency Act 1986;

~~if an order is made by the court claiming jurisdiction on the ground of mental disorder for the director's detention or for the appointment of a guardian or for the appointment of a person to exercise powers in respect of such director's property or affairs;~~

if the director is absent from meetings of directors for six months without leave and the directors resolve that such director's office be vacated; or

if a written notice is served on him (signed by no less than three-quarters of the directors) to the effect that such director's office shall be vacated.

#### **DIRECTORS' SHARE QUALIFICATION**

A director is not required to hold any shares of Lloyds Banking Group plc by way of qualification.

190



ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

**DIRECTORS' INDEMNITY/INSURANCE**

So far as may be permitted by the statutes, any person who is or was at any time a director, officer, employee or trustee of Lloyds Banking Group plc (or any associated company) may be indemnified by Lloyds Banking Group plc against any liability incurred by him in connection with any negligence, default, breach of duty or breach of trust by him in relation to Lloyds Banking Group plc (or any associated company) or any other liability incurred in the execution of his duties, the exercise of his powers or otherwise in connection with his duties, powers or offices. The directors of Lloyds Banking Group plc may also purchase and maintain insurance in respect of such liabilities. So far as may be permitted by the statutes, Lloyds Banking Group plc may also provide defence costs in relation to any criminal, civil or regulatory proceedings to which any current or former director, officer, employee or trustee of Lloyds Banking Group plc (or any associated company) is subject and do anything to enable any such a person to avoid incurring such expenditure.

**AUTHORISATION OF DIRECTORS' INTERESTS**

Subject to the provisions of the statutes, the directors can authorise any matter which would or might otherwise constitute or cause a breach of the duty of a director to avoid a situation in which he has or can have a direct or indirect interest that conflicts, or possibly may conflict, with the interests of Lloyds Banking Group plc.

Such authorisation of a matter shall be effective only if the matter in question shall have been proposed in writing for consideration at a meeting of the directors in accordance with the board's normal procedures or in such other manner as the directors may determine, the quorum requirement for the meeting of directors at which the matter is considered is satisfied and the matter is (or would have been) agreed to without the interested directors voting.

Any authorisation of a matter under the Articles of Association shall be subject to such conditions or limitations as the directors may determine, whether at the time such authorisation is given or subsequently, and may be terminated by the directors at any time. A director shall comply with any obligations imposed on him pursuant to any such authorisation.

A director shall not, save as otherwise agreed by him, be accountable to Lloyds Banking Group plc for any benefit which he (or a person connected with him) derives from any matter authorised by the directors and any contract, transaction or arrangement relating thereto shall not be liable to be avoided on the grounds of any such benefit.

Where a director has an interest which can reasonably be regarded as likely to give rise to a conflict of interest, the director may, and shall if so requested by the directors, take such additional steps as may be necessary or desirable for the purpose of managing such conflict of interest, including compliance with any procedures laid down from time to time by the directors.

Lloyds Banking Group plc may by ordinary resolution ratify any contract, transaction or arrangement, or other proposal, not properly authorised under the Articles of Association.

## **MATERIAL INTERESTS**

In general, the Companies Act requires that a director disclose to Lloyds Banking Group plc any personal interest that he may have and all related material information and documents known to him, in connection with any existing or proposed transaction by Lloyds Banking Group plc. The disclosure is required to be made promptly and in any event, no later than at the board of directors meeting in which the transaction is first discussed.

Subject to the provisions of the statutes, the director (or a person connected with him), provided that the director has declared the nature and extent of any interest as required under the Articles of Association:

may be a director or other officer of, or be employed by, or otherwise interested (including by the holding of shares) in Lloyds Banking Group plc, a subsidiary undertaking of Lloyds Banking Group plc, any holding company of Lloyds Banking Group plc, a subsidiary undertaking of any such holding company, or any body corporate promoted by Lloyds Banking Group plc or in which Lloyds Banking Group plc is otherwise interested (a relevant company);

may be a party to, or otherwise interested in, any contract, transaction or arrangement with a relevant company (or in which the company is otherwise interested);

may (and any firm of which he is a partner, employee or member may) act in a professional capacity for any relevant company (other than as auditor) and be remunerated therefor;

–may have an interest which cannot reasonably be regarded as likely to give rise to a conflict of interest;

may have an interest, or a transaction or arrangement giving rise to such an interest, of which the director is not aware; and

–may have any other interest authorised under the Articles of Association or by shareholder resolution.

Subject to the provisions of the Companies Act, a director is entitled to vote and be counted in the quorum in respect of any resolution concerning any contract, transaction or arrangement or any other proposal:

~~in which he has an interest of which he is not aware;~~

~~in which he has an interest which cannot reasonably be regarded as likely to give rise to a conflict of interest;~~

~~in which he has an interest only by virtue of interests in shares, debentures or other securities of the company, or by reason of any other interest in or through Lloyds Banking Group plc;~~

~~which involves the giving of any security, guarantee or indemnity to the director or any other person in respect of (i) money lent or obligations incurred by him or by any other person at the request of or for the benefit of the company or any of its subsidiary undertakings; or (ii) a debt or other obligation of the company or any of its subsidiary undertakings for which he himself has assumed responsibility in whole or in part under a guarantee or indemnity or by the giving of security;~~

~~concerning an offer of shares or debentures or other securities of or by the company or any of its subsidiary undertakings (i) in which offer he is or may be entitled to participate as a holder of securities; or (ii) in the underwriting or subunderwriting of which he is to participate;~~

191

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

concerning any other body corporate in which he is interested, directly or indirectly and whether as an officer, shareholder, creditor, employee or otherwise, provided that he (together with persons connected with him) is not the holder of, or beneficially interested in, one per cent or more of the issued equity share capital of any class of such body corporate or of the voting rights available to members of the relevant body corporate;

relating to an arrangement for the benefit of the employees or former employees of the company or any of its subsidiary undertakings which does not award him any privilege or benefit not generally awarded to the employees or former employees to whom such arrangement relates;

concerning the purchase or maintenance by the company of insurance for any liability for the benefit of directors or for the benefit of persons who include directors;

concerning the giving of indemnities in favour of directors;

concerning the funding of expenditure by any director or directors on (i) defending criminal, civil or regulatory proceedings or actions against him or them, (ii) in connection with an application to the court for relief, or (iii) defending him or them in any regulatory investigations (and doing anything to enable any director or directors to avoid incurring such expenditure); and

in respect of which his interest, or the interest of directors generally, has been authorised by ordinary resolution.

Except as set out above and subject to the Companies Act, a director shall not be entitled to vote on any resolution in respect of any contract, transaction or arrangement, or any other proposal, in which he (or a person connected with him) is interested. Any vote of a director in respect of a matter where he is not entitled to vote shall be disregarded. A director shall not be counted in the quorum for a meeting of the directors in relation to any resolution on which he is not entitled to vote.

If a question arises at any time as to whether any interest of a director prevents him from voting, or being counted in the quorum, and such question is not resolved by his voluntarily agreeing to abstain from voting, such question shall be referred to the chairman of the meeting and his ruling in relation to any director other than himself shall be final and conclusive, provided that the nature or extent of the interest of such director has been fairly disclosed. If any such question shall arise in respect of the chairman of the meeting, the question shall be decided by resolution of the directors and the resolution shall be conclusive provided that the nature or extent of the interest of the chairman of the meeting has been fairly disclosed to the directors.

**CONFIDENTIAL INFORMATION**

If a director, otherwise than by virtue of his position as director, receives information in respect of which he owes a duty of confidentiality to a person other than Lloyds Banking Group plc, he shall not be required to disclose such information to Lloyds Banking Group plc or otherwise use or apply such confidential information for the purpose of

or in connection with the performance of his duties as a director, provided that such an actual or potential conflict of interest arises from a permitted or authorised interest under the Articles of Association. This is without prejudice to any equitable principle or rule of law which may excuse or release the director from disclosing information, in circumstances where disclosure may otherwise be required under the Articles of Association.

## **REMUNERATION**

Lloyds Banking Group plc must obtain a binding vote of shareholders on remuneration policy at least once every three years and an advisory vote on an implementation report on how the remuneration policy was implemented in the relevant financial year.

The ordinary remuneration of the directors is determined by the directors except that such ordinary remuneration shall not exceed £1,000,000 per annum in aggregate or such higher amount as may from time to time be determined by ordinary resolution of Lloyds Banking Group plc. Such ordinary remuneration is (unless otherwise provided by ordinary resolution of Lloyds Banking Group plc) divisible among the directors as they may agree, or, failing agreement, equally. However, any director who holds office for only part of the period in respect of which remuneration is payable shall be entitled only to rank in such division for a proportion of the remuneration relating to the period during which he has held office.

Any director who holds an executive office, or who serves on any committee of the directors, or who otherwise performs services which in the opinion of the directors are outside the scope of the ordinary duties of a director, may be paid extra remuneration by way of salary, commission or otherwise or may receive such other benefits as the directors may determine in their discretion. Such extra remuneration or other benefits are in addition to, or in substitution for, any or all of a director's entitlement to ordinary remuneration.

Where proposals are under consideration concerning the appointment (including fixing or varying the terms of appointment) of two or more directors to offices or employments with Lloyds Banking Group plc (or any body corporate in which Lloyds Banking Group plc is interested), the proposals may be divided and considered in relation to each director separately. In such case, each of the directors concerned shall be entitled to vote, and be counted in the quorum, in respect of each resolution except that concerning his own appointment or the fixing or variation of the terms thereof.

The directors may repay to any director all such reasonable expenses as he may incur in attending and returning from meetings of the directors or of any committee of the directors or general meetings or otherwise in connection with the business of Lloyds Banking Group plc. The directors have the power to pay and agree to pay gratuities, pensions or other retirement, superannuation, death or disability benefits to, or to any person in respect of, any director or ex-director.

## **ELECTRONIC COMMUNICATIONS**

Subject to and in accordance with statute, Lloyds Banking Group plc has the right to offer shareholders the opportunity to have documents and information made available to them through Lloyds Banking Group plc's website and in electronic form.

## **EXCHANGE CONTROLS**

There are no UK laws, decrees or regulations that restrict Lloyds Banking Group plc's export or import of capital, including the availability of cash and cash equivalents for use by Lloyds Banking Group, or that affect the remittance of dividends or other shareholders' payments to non-UK holders of Lloyds Banking Group plc shares, except as set out in *Taxation*.

192

## TAXATION

### UK TAXATION

The following discussion is intended only as a general guide to current UK tax legislation, what is understood to be current UK HM Revenue & Customs practice and the terms of the current UK/US income tax treaty (the Treaty), all of which are subject to change at any time, possibly with retroactive effect.

The Treaty for the avoidance of double taxation with respect to taxes on income entered into force following the exchange of instruments of ratification by the UK Parliament and the US Senate on 31 March 2003.

The UK HM Revenue & Customs is the UK government department responsible for assessing and collecting UK tax revenues. The discussion is intended as a general guide and only applies to persons who are the beneficial owners of their ordinary shares or ADSs. References below to a US holder are to that term as defined, and subject to the exclusions described in the introduction below under *US federal income tax considerations*. It may not apply to certain shareholders or ADS holders, such as dealers in securities.

Tax can be complicated and individual circumstances may need to be considered in more detail. Any person who is in any doubt as to his tax position should consult his own professional adviser.

### TAXATION OF CHARGEABLE GAINS

#### UK RESIDENTS

A disposal (or deemed disposal) of ordinary shares or ADSs by a shareholder or holder of ADSs resident or (in the case of an individual) ordinarily resident for tax purposes in the UK may, depending on the shareholder's or ADS holder's particular circumstances, and subject to any available exemption or relief, give rise to a chargeable gain or an allowable loss for the purposes of UK taxation on chargeable gains.

#### INDIVIDUALS, OTHER THAN US HOLDERS, TEMPORARILY NON-RESIDENT IN THE UK

A shareholder or ADS holder who is an individual and who has, on or after 17 March 1998, ceased to be resident and ordinarily resident for tax purposes in the UK for a period of five years or less of assessment and who disposes of ordinary shares or ADSs during that period may be liable, on return to the UK, to UK taxation on chargeable gains arising during the period of absence, subject to any available exemption, relief and/or foreign tax credit.

## **US HOLDERS**

Subject to the provisions set out in the next paragraph in relation to temporary non-residents, US holders generally will not be liable for UK tax on chargeable gains unless they carry on a trade, profession or vocation in the UK through a branch or agency and the ordinary shares or ADSs are or have been used or held by or for the purposes of the branch or agency, in which case such US holder might, depending on individual circumstances, be liable to UK tax on chargeable gains on any disposition of ordinary shares or ADSs.

An individual US holder who is only temporarily not resident in the UK may, under anti-avoidance legislation, still be liable for UK tax on chargeable gains realised, subject to any available exemption, relief and/or foreign tax credit.

A US holder who is an individual and who has, on or after 17 March 1998, ceased to be resident or ordinarily resident for tax purposes in the UK for a period of five years or less of assessment and who disposes of ordinary shares or ADSs during that period may be liable, on return to the UK, to UK taxation on chargeable gains arising during the period of absence, subject to any available exemption, relief and/or foreign tax credit.

## **OTHER NON-UK RESIDENT PERSONS**

Subject to the provisions set out above under *Individuals, other than US holders, temporarily non-resident in the UK*, shareholders or ADS holders who are neither resident nor ordinarily resident in the UK generally will not be liable for UK tax on chargeable gains unless they carry on a trade, profession or vocation in the UK through a branch or agency and the ordinary shares or ADSs are or have been used or held by or for the purposes of the branch or agency, in which case such shareholders or ADS holders might, depending on individual circumstances, be liable to UK tax on chargeable gains on any disposition of ordinary shares or ADSs. An individual holder of ordinary shares or ADSs who is only temporarily not resident in the UK may, under anti-avoidance legislation, still be liable for UK tax on chargeable gains realised, subject to any available exemption, relief and/or foreign tax credit.

## **TAXATION OF DIVIDENDS**

### **UK RESIDENTS**



Lloyds Banking Group plc will not be required to withhold tax at source when paying a dividend on the ordinary shares or ADSs.

Up until April 2016, an individual shareholder or ADS holder who is resident in the UK for tax purposes was entitled to a tax credit in respect of any dividend received from Lloyds Banking Group plc and will be taxable on the gross dividend, which is the aggregate of the dividend received and related tax credit. The value of the tax credit will be equal to one-ninth of the dividend received (and, therefore, 10 per cent of the gross dividend). The gross dividend will be treated as an individual's marginal taxable income. The tax credit will, however, be treated as discharging the individual's liability to income tax in respect of the gross dividend, unless and except to the extent that the gross dividend falls above the threshold for the higher rate of income tax. A UK resident individual shareholder or ADS holder who is liable to income tax at the higher rate or additional rate (higher rate is 40 per cent for the 2015-2016 and 2016-2017 tax years and additional rate is 45 per cent for the 2015-2016 and 2016-2017 tax years) will be subject to tax at the rate applicable to dividends for such shareholders or ADS holders (32.5 per cent for higher rate taxpayers for the 2015-2016 tax year, 37.5 per cent for additional rate taxpayers for the 2015-16 tax year) on the gross dividend. The tax credit will be set against but will not fully discharge such shareholders' or ADS holders' tax liability on the gross dividend and they will have to pay additional tax. The additional tax is 22.5 per cent of the gross dividend for higher rate taxpayers and 27.5 per cent for additional rate taxpayers for the 2015-16 tax year.

There will be no payment of the tax credit or any part of it to an individual whose liability to income tax on the dividend and the related tax credit is less than the tax credit.

After April 2016, the 10 per cent tax credit will be replaced with a £5,000 tax free dividend allowance. Dividends received above the allowance will be taxed at 7.5 per cent to the extent that the dividend falls within the threshold for basic rate of income tax. A UK resident individual shareholder or ADS holder who is liable to income tax at the higher rate or additional rate will be subject to tax at the rate applicable to dividends for such shareholders or ADS holders (32.5 per cent for higher rate taxpayers and 38.1 per cent for additional rate taxpayers for the 2016-2017 tax year) on dividends received.

## TAXATION

UK resident shareholders or ADS holders who are not liable to UK tax on dividends, including pension funds and charities, will not be entitled to the payment of any tax credits in respect of dividends.

Subject to certain exceptions, such as for dealers in securities and for some insurance companies with overseas business, UK resident corporate shareholders or ADS holders will generally not be subject to corporation tax in respect of dividends received from Lloyds Banking Group plc, but will not be entitled to the payment of any tax credit with respect to the dividends.

Shareholders who are within the charge to corporation tax will be subject to corporation tax on dividends paid by the Company, unless (subject to special rules for such shareholders that are small companies) the dividends fall within an exempt class and certain other conditions are met. It is expected that the dividends paid by the Company would generally be exempt. Such shareholders will not be able to claim repayment of tax credits attaching to dividends.

## US HOLDERS

Lloyds Banking Group plc will not be required to withhold tax at source when paying a dividend on the ordinary shares or ADSs to a US holder. US holders of ADSs or ordinary shares who receive a dividend from Lloyds Banking Group plc will not have any UK tax to pay in respect of the dividend.

## OTHER NON-UK RESIDENT PERSONS

Lloyds Banking Group plc will not be required to withhold tax at source when paying a dividend on the ordinary shares or ADSs to a holder, other than a US holder, who is not resident for tax purposes in the UK.

Holders of ordinary shares or ADSs, other than US holders, who are not resident for tax purposes in the UK and who receive a dividend from Lloyds Banking Group plc will not have any UK tax to pay in respect of the dividend, but will not normally be able to claim any additional payment in respect of the dividend from the UK HM Revenue & Customs under any applicable Double Tax Treaty.

## STAMP DUTY AND STAMP DUTY RESERVE TAX

## **UK RESIDENTS, US HOLDERS AND OTHER NON-UK RESIDENT PERSONS**

Any conveyance or transfer on sale of ordinary shares (whether effected using the CREST settlement system or not) will be subject to UK stamp duty or stamp duty reserve tax (SDRT). The transfer on sale of ordinary shares will be liable to ad valorem UK stamp duty or SDRT, generally at the rate of 0.5 per cent of the consideration paid (rounded up to the next multiple of £5 in the case of stamp duty). Stamp duty is usually the liability of the purchaser or transferee of the ordinary shares. An unconditional agreement to transfer such ordinary shares will be liable to SDRT, generally at the rate of 0.5 per cent of the consideration paid, but such liability will be cancelled, or, if already paid, refunded, if the agreement is completed by a duly stamped transfer within six years of the agreement having become unconditional. SDRT is normally the liability of the purchaser or transferee of the ordinary shares.

Where Lloyds Banking Group plc issues ordinary shares or a holder of ordinary shares transfers such shares to the custodian or nominee for the depository to facilitate the issue of ADSs to a person representing the ordinary shares or to a person providing clearance services (or their nominee or agent), a liability to UK stamp duty or SDRT at the rate of 1.5 per cent (rounded up to the next multiple of £5 in the case of the stamp duty) of either the issue price or, in the case of transfer, the listed price of the ordinary shares, calculated in sterling, will arise. However, following the case before the European Court of Justice (Case C-569/07 HSBC Holdings plc and Vidacos Nominees v The Commissioners for HM Revenue & Customs) HMRC now accepts that the charge to SDRT at 1.5 per cent on the issue of shares into clearance services or depository receipt schemes is prohibited. Where a holder of ordinary shares transfers such shares to the custodian or nominee for the depository or clearance services this charge will generally be payable by the person receiving the ADSs or transferring the ordinary shares into the clearance service.

No liability to stamp duty or SDRT will arise as a result of the cancellation of any ADSs with the ordinary shares that they represent being transferred to the ADS holder.

No liability to UK stamp duty or SDRT will arise on a transfer of ADSs provided that any document that effects such transfer is not executed in the UK and that it remains at all subsequent times outside the UK. An agreement to transfer ADSs will not give rise to a liability to SDRT.

## **US FEDERAL INCOME TAX CONSIDERATIONS**

The following summary describes material US federal income tax consequences of the ownership and disposition of ADSs or ordinary shares to the US holders described below, but it does not purport to be a comprehensive description of all of the tax considerations that may be relevant to a decision to own such securities. The summary applies only to US holders that hold ADSs or ordinary shares as capital assets for US federal income tax purposes. This discussion does not address any alternative minimum or Medicare Contribution tax consequences, nor does it address US federal tax consequences to US holders that are subject to special rules, such as:

-certain financial institutions;

-dealers or traders in securities that use a mark-to-market method of tax accounting;

persons holding ADSs or ordinary shares as part of a hedge, straddle, wash sale, conversion or other integrated transaction or holders entering into a constructive sale with respect to ADSs or ordinary shares;

-persons whose functional currency for US federal income tax purposes is not the US dollar;

persons who acquired ADSs or ordinary shares pursuant to the exercise of any employee stock option or otherwise as compensation;

-tax-exempt entities, including 'individual retirement accounts' or 'Roth IRAs';

persons holding ADSs or ordinary shares in connection with a trade or business conducted outside of the United States;

-partnerships or other entities classified as partnerships for US federal income tax purposes; or

-persons that own or are deemed to own 10 per cent or more of the voting shares of Lloyds Banking Group plc.

If an entity that is classified as a partnership for US federal income tax purposes holds ADSs or ordinary shares, the US federal income tax treatment of a partner will generally depend on the status of the partner and the activities of the partnership. Partnerships holding ADSs or ordinary shares and partners

## TAXATION

in such partnerships should consult their tax advisers as to the particular US federal income tax consequences of holding and disposing of the ADSs or ordinary shares.

This summary is based on the US Internal Revenue Code of 1986, as amended (the Code), administrative pronouncements, judicial decisions and final, temporary and proposed Treasury Regulations, as well as the Treaty, all as of the date hereof, changes to any of which may affect the tax consequences described herein, possibly with retroactive effect. It is also based in part on representations of the depositary and assumes that each obligation provided for in or otherwise contemplated by the Deposit Agreement or any other related document will be performed in accordance with its terms.

As used herein, a 'US holder' is a beneficial owner of ADSs or ordinary shares that is, for US federal income tax purposes:

-a citizen or individual resident of the United States;

-a corporation, or other entity taxable as a corporation, created or organised in or under the laws of the United States, any state therein or the District of Columbia; or

-an estate or trust the income of which is subject to US federal income taxation regardless of its source.

In general, a US holder who owns ADSs should be treated as the owner of the underlying shares represented by those ADSs for US federal income tax purposes. Accordingly, no gain or loss should be recognised if a US holder exchanges ADSs for the underlying shares represented by those ADSs.

The US Treasury has expressed concerns that parties to whom American depositary shares are released before shares are delivered to the depositary ('pre-release'), or intermediaries in the chain of ownership between holders and the issuer of the security underlying the American depositary shares, may be taking actions that are inconsistent with the claiming of foreign tax credits by US holders of American depositary shares. Such actions would also be inconsistent with the claiming of the reduced rate of tax applicable to dividends received by certain non-corporate US holders. Accordingly, the availability of the preferential tax rate for dividends received by certain non-corporate US holders, described below, could be affected by actions taken by such parties or intermediaries.

Owners of ADSs or ordinary shares should consult their tax advisers as to the US, UK or other tax consequences of the ownership and disposition of such securities in their particular circumstances, including the effect of any US state or local tax laws.

## **TAXATION OF DISTRIBUTIONS**

Distributions paid on ADSs or ordinary shares, other than certain pro rata distributions of ordinary shares, will generally be treated as dividends to the extent paid out of Lloyds Banking Group plc's current or accumulated earnings and profits (as determined in accordance with US federal income tax principles). Because Lloyds Banking Group plc does not maintain calculations of its earnings and profits under US federal income tax principles, it is expected that distributions generally will be reported to US holders as dividends. The dividends will generally be foreign-source income to US holders and will not be eligible for the dividends-received deduction generally allowed to US corporations under the Code.

Subject to applicable limitations and the discussion above regarding concerns expressed by the US Treasury, dividends paid to certain non-corporate US holders may be taxable at favourable rates. Non-corporate US holders should consult their tax advisers to determine whether the favourable rates will apply to dividends they receive and whether they are subject to any special rules that limit their ability to be taxed at these favourable rates.

Dividends will be included in a US Holder's income on the date of the US Holder's or, in the case of ADSs, the depositary's receipt of the dividend. The amount of a dividend will equal the US dollar value of the pounds sterling received, calculated by reference to the exchange rate in effect on the date of receipt regardless of whether the payment is converted into US dollars on the date of receipt. If the pounds sterling received as a dividend are not converted into US dollars on the date of receipt, then the US holder's tax basis in the pounds sterling received will equal such US dollar value and the US holder may realise a foreign exchange gain or loss on the subsequent conversion into US dollars. Generally, any gains or losses resulting from the conversion of pounds sterling into US dollars will be treated as US-source ordinary income or loss.

## **TAXATION OF CAPITAL GAINS**

Gain or loss realised by a US holder on a sale or other disposition of ADSs or ordinary shares will generally be subject to US federal income tax as capital gain or loss in an amount equal to the difference between the US holder's tax basis in the ADSs or ordinary shares disposed of and the amount realised on the disposition, in each case as determined in US dollars. Gains or losses, if any, will generally be US-source and will be long-term if the US Holder held the ADSs or ordinary shares for more than one year. The deductibility of losses is subject to limitations.

## **INFORMATION REPORTING AND BACKUP WITHHOLDING**

Dividends paid on, and the sale proceeds from, ADSs or ordinary shares that are made within the US or through certain US-related financial intermediaries may be subject to information reporting and backup withholding requirements unless the US holder:

-is a corporation or other exempt recipient, or

in the case of backup withholding, the US holder provides a correct taxpayer identification number and certifies that it is not subject to backup withholding.

The amount of any backup withholding from a payment to a US holder will be allowed as a credit against the US holder's US federal income tax liability and may entitle it to a refund, provided that the required information is timely furnished to the Internal Revenue Service.

195

## WHERE YOU CAN FIND MORE INFORMATION

The documents concerning the Lloyds Banking Group which are referred to herein may be inspected at the Securities and Exchange Commission (SEC). You may read and copy any document filed or furnished by the Group at the SEC's public reference room in Washington D.C., at 100 F Street, N.E., Washington D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the reference rooms. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) which contains, in electronic form, each of the reports and other information that the Group has filed electronically with the SEC.

## ENFORCEABILITY OF CIVIL LIABILITIES

Lloyds Banking Group plc is a public limited company incorporated under the laws of Scotland. Most of Lloyds Banking Group plc's directors and executive officers and certain of the experts named herein are residents of the UK. A substantial portion of the assets of Lloyds Banking Group plc, its subsidiaries and such persons, are located outside the United States. As a result, it may not be possible for investors to effect service of process within the United States upon all such persons or to enforce against them in US courts judgments obtained in such courts, including those predicated upon the civil liability provisions of the federal securities laws of the United States. Furthermore, Lloyds Banking Group plc has been advised by its solicitors that there is doubt as to the enforceability in the UK, in original actions or in actions for enforcement of judgments of US courts, of certain civil liabilities, including those predicated solely upon the federal securities laws of the United States.



## RISK FACTORS

Set out below are certain risk factors which could affect Lloyds Banking Group's future results and cause them to differ from expected results in material respects. The factors discussed below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties that Lloyds Banking Group's businesses face. For information on Lloyds Banking Group's risk management policies and procedures, see '*Lloyds Banking Group — Operating and financial review and prospects—Risk Management.*'

## CREDIT-RELATED RISKS

**The Group's businesses are subject to inherent risks concerning borrower and counterparty credit quality which have affected and may adversely impact the recoverability and value of assets on the Group's balance sheet.**

The Group has exposures (including, but not limited to, lending, undrawn commitments, derivative, equity, contingent and/or settlement risks) to many different products, counterparties and obligors and the credit quality of its exposures can have a significant impact on the Group's earnings. Credit risk exposures are categorised as "retail", arising primarily in the Retail, Consumer Finance and parts of the Run-Off divisions, and small and medium-sized enterprises (SME) and "corporate" (including medium and large corporates, banks, financial institutions and sovereigns), arising primarily in the Commercial Banking, Run-Off and Insurance divisions. This reflects the risks inherent in the Group's lending and lending-related activities and in the insurance business primarily in respect of investment holdings (including loan assets) and exposures to reinsurers. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties or collateral held in support of exposures, or in their behaviour or businesses, may reduce the value of the Group's assets and materially increase the Group's write-downs and allowances for impairment losses. Credit risk can be affected by a range of factors outside the Group's control, which include but are not limited to an adverse economic environment (in the UK and/or in countries where the Group and/or its customers/counterparties do and do not operate, such as any adverse economic effects that could occur in connection with the UK's exit from the EU following the referendum decision), reduced UK consumer and/or government spending (in light of the Group's concentration in the UK), global economic slowdown leading to constraints on liquidity (given continued concerns around the Eurozone, adverse economic environments in China and emerging markets and other macro-economic issues), changes in the credit rating of individual counterparties (including sovereigns), the debt levels of individual contractual counterparties and the economic environment in which they operate, increased unemployment, reduced asset values, increased personal or corporate insolvency levels, adverse sector concerns, falling stock and bond/other financial markets, reduced corporate profits, over-indebtedness (including sovereigns), changes (and the timing, quantum and pace of these changes) in interest rates (including the potential increase in the use of negative interest rates), and any subsequent impact on pension liabilities, volatility of oil and commodity prices, changes in foreign exchange rates, higher tenant defaults, counterparty challenges to the interpretation or validity of contractual arrangements, an increase in credit spreads, changes to insolvency regimes making it harder to enforce against counterparties, impact of technological disruption or cybercrime and any external factors of a political, legislative or regulatory nature, including for example, rising "living wage" requirements, changes in accounting rules and tax changes relating to buy-to-let investments in the UK.

The EU referendum decision has heightened the probability of some or all of these events happening and adds further uncertainty to counterparty credit risk and the Group's financial condition. Key related risks which may impact the Group's business and/or the Group's clients' businesses include, but are not limited to: weaker sterling, volatility in financial markets, a downgrade of the UK credit rating, inflation risk, prolonged low or rising interest rates, impact on European sovereigns and counterparties, reduced consumer spending, dampened confidence, loss and/or postponement of foreign direct investment and domestic direct investment, political uncertainty, potential wider European political instability, uncertainty around trade negotiations and/or the UK's ability to retain access to the single market, passporting and free movement and cost of labour, relocation of companies and institutions away from the UK, and the withdrawal and/or reduction of EU funding. For more detail on the EU referendum decision see "*—Business and Economic Risks— Political, legal, regulatory, constitutional and economic uncertainty arising from the outcome of the referendum on the UK's membership of the EU could adversely impact the Group's business, results of operations, financial condition and prospects*" below. For further information on general macro-economic risks affecting the Group in the UK and the EU see "*— Business and Economic Risks— The Group's businesses are subject to inherent and indirect risks arising from general macro-economic conditions in the UK, the US, the Eurozone, Asia and globally, and any resulting instability of financial markets or banking systems*".

There are many other factors that could impact credit risk including fraud, natural disasters, flooding, industrial and strike action, war and acts of terrorism.

The Group has credit exposure both in the UK and internationally, including Europe, the US and Asia. The Group's credit exposure includes residential mortgage lending (in the UK and to a lesser extent, Ireland and The Netherlands) and commercial real estate lending, including commercial real estate lending secured against secondary and tertiary non-prime assets in the UK. The Group also has significant credit exposure to certain individual counterparties in higher risk and cyclical asset classes and sectors (such as leveraged lending, oil and gas and related sectors, commodities trading, manufacturing (including auto manufacturers), construction, retail and outsourcing services) and weakened geographic markets and to counterparties whose businesses may be impacted by material unforeseen events. In addition, the Group has concentrated country exposure in the UK and within certain industry sectors, namely real estate and real estate-related sectors and financial intermediation including providing facilities to funds, mainly against high quality (investment grade equivalent) investors. Certain industry sectors have been adversely impacted by recent global economic events; for example the oil and gas and related sectors, manufacturing (including auto manufacturers) and commodities trading and such adverse developments in these sectors increases the risk of default by the Group's customers in these sectors. The Group's retail customer portfolios (including those in the Retail, Consumer Finance and Run-Off divisions) will remain strongly linked to the UK economic environment, with house price deterioration, unemployment increases, inflationary pressures, consumer over-indebtedness and prolonged low or rising interest rates among the factors that may impact secured and unsecured retail credit exposures.

In recent years, a number of factors, such as Eurozone instability (including the risk of economic stagnation/deflation in the Eurozone or of one or more members leaving the Eurozone), the deterioration of capital market conditions, the global economic slowdown (given slowdown in economic growth across China and emerging markets and other macro-economic issues) and measures adopted by the governments of individual countries, have reduced and could further reduce households' disposable income and businesses' profitability. In the UK, the sterling's depreciation is expected to squeeze households' real incomes by pushing up import prices. If such volatile conditions were to continue or increase, this could also have a negative impact on customers' ability to honour their obligations, which in turn would result in deterioration of the Group's credit quality. If political conditions or uncertainty over the Eurozone, or the UK Government and Eurozone austerity measures and public spending cuts, result in a prolonged period of

economic stagnation for the UK or Eurozone, or a slowdown in the rate of economic recovery, or there is a broader economic slowdown, it may lead to further weakening of counterparty credit quality and subsequent higher impairment charges or fair value reductions in the Group's lending and contingent equity and derivative portfolios. This could have a material adverse effect on the Group's results of operations, financial condition or prospects.

## RISK FACTORS

The possibility of prolonged economic stagnation in the EU or the risk of one or more members leaving the EU (including the UK's exit from the EU following the referendum decision), or the risk of a Eurozone member leaving the Eurozone, could impact the UK's own economic recovery, given the extensive trade links between the UK and the Eurozone/EU and in turn, this could impact upon the Group's performance. The Group has credit exposure to SMEs and corporates, financial institutions and securities which may have material direct and indirect exposures in the Eurozone countries. Any default on the sovereign debt of these countries and the resulting impact on other Eurozone countries, including the potential that some countries could leave the Eurozone, could have a material adverse effect on the Group's business.

At present, default rates are partly cushioned by low rates of interest which have helped customer affordability, but the risk remains of increased default rates as interest rates start to rise. The timing, quantum and pace of any change in interest rates is a key risk factor for the Group's default rates with expectations on the timing and quantum of any changes set by the Bank of England and also by the relevant central bank when lending in a foreign currency.

All new lending is dependent on the Group's assessment of each customer's ability to repay and the value of any underlying security. There is an inherent risk that the Group has incorrectly assessed the credit quality and/or the ability or willingness of borrowers to repay, possibly as a result of incomplete or inaccurate disclosure by those borrowers or as a result of the inherent uncertainty that is involved in the exercise of constructing models to estimate the true risk of lending to counterparties. The Group estimates and establishes reserves for credit risks and potential credit losses inherent in its credit exposure. This process, which is critical to the Group's results and financial condition, requires difficult, subjective and complex judgements, including forecasts of how macro-economic conditions might impair the ability of borrowers to repay their loans. As is the case with any such assessments, there is always a risk that the Group will fail to adequately identify the relevant factors or that it will fail to estimate accurately the impact of these identified factors.

### **Concentration of credit and market risk could increase the Group's potential for significant losses including in an adverse market/environment.**

The Group has exposure to concentration risk where its business activities focus particularly on a single obligor or a similar type of customer (borrower, sovereign, financial institution or central counterparty), product, industrial sector or geographic location, including the UK.

The Group has significant exposure to the UK residential mortgage market. Additionally, the Group has large sectorial concentrations (primarily in gilts, real estate and real estate-related lending, and financial intermediation including providing facilities to funds, mainly against high quality (investment grade equivalent) investors and to a lesser extent, oil and gas and related sectors, manufacturing (including auto manufacturers), agriculture and leveraged lending), as well as significant global credit exposure.

The Group has significant real estate and real estate-related exposure, including secondary and tertiary non-prime assets, meaning that decreases in residential or commercial property values and/or increases in tenant defaults are likely to lead to higher impairment charges, which could materially affect the Group's results of operations, financial condition or prospects.

The Group's corporate lending portfolio also contains substantial exposure to large, mid-sized, public and private companies. Exposures to sectors that have experienced cyclical weakness in recent years, coupled with a historic strategy of taking large single name concentrations to non-listed companies and entrepreneurs, and taking exposure at various levels of the capital structure, may give rise to (albeit reducing) single name and risk capital exposure. Whilst expectation of default for these exposures is appropriately provided for within the Group's base case assumptions, they remain vulnerable to downside risks. As in the UK, the Group's lending business overseas is also exposed to a small number of long-term customer relationships and these single name concentrations place the Group at risk of loss should default occur.

The Group's efforts to continue to divest, diversify or manage its credit portfolio against concentration risks may not be successful and any concentration of credit risk could increase the potential for significant losses in its credit portfolio. In addition, any disruption in the liquidity or transparency of the financial markets may result in the Group's inability to sell or syndicate securities, loans or other instruments or positions held (including underwrites), thereby leading to increased concentrations of such positions. These concentrations could expose the Group to losses if the mark-to-market value of the securities, loans or other instruments or positions declines causing the Group to take write-downs. Moreover, the inability to reduce the Group's positions not only increases the market and credit risks associated with such positions, but also increases the level of risk-weighted assets on the Group's balance sheet, thereby increasing its capital requirements and funding costs, all of which could materially adversely affect the Group's operating results, financial condition or prospects.

The Group's corporate portfolios are also susceptible to "fallen angel" risk, that is, the probability of default increases significantly following material unexpected events, resulting in the potential for large losses. These types of events can occur from time to time, and may include for example, major fraud, poor corporate governance, high profile incidents and collapse in specific sectors or products, all of which are very difficult to forecast, and could adversely impact the Group's results of operations, financial condition or prospects.

**The Group may be required to record credit value adjustments, funding value adjustments and debit value adjustments on its derivative portfolio, which could have a material adverse effect on the Group's results of operations, financial condition or prospects.**

The Group continually seeks to limit and manage counterparty credit risk exposure to market counterparties. Credit value adjustment (CVA) and funding value adjustment (FVA) reserves are held against uncollateralised derivative exposures and a risk management framework is in place to mitigate reserve value changes. CVA is an expected loss calculation that incorporates current market factors including counterparty credit spreads. FVA reserves are held to capitalise the cost of funding uncollateralised derivative exposures. The Group also calculates a debit value adjustment (DVA) to reflect own credit spread risk as part of the fair value of derivative liabilities. The Group uses several credit risk mitigation techniques to limit counterparty credit risk exposure including netting agreements, collateral agreements and other forms of credit enhancement where possible. However, deterioration in the

creditworthiness of financial counterparties, or large adverse financial market movements, could impact the size of CVA and FVA reserves and result in a material charge to the Group's profit and loss account.

## **CONDUCT RISKS**

**The Group is exposed to various forms of conduct risk in its operations, including the risk of mis-selling financial products, mishandling of complaints, business planning and strategy not being based upon customer need and not supporting fair customer outcomes, and engaging in conduct which disrupts the fair and effective operation of a market in which it is active, any of which could have a material adverse effect on the Group's results or its relations with its customers and regulators.**

The Group is exposed to various forms of conduct risk in its operations. Such risks are inherent in banking services. These include business and strategic planning that does not sufficiently consider customer need (leading to products being offered beyond target markets and mis-selling of financial products), ineffective management and monitoring of products and their distribution (which could result in customers receiving unfair outcomes), a

## RISK FACTORS

culture that is not sufficiently customer-centric (potentially driving improper decision making and unfair outcomes for customers), outsourcing of customer service and product delivery via third parties that do not have the same level of control, oversight and culture as the Group (resulting in unfair customer outcomes which could lead to reputational damage and regulatory investigations), the possibility of alleged mis-selling of financial products or the mishandling of complaints related to the sale of such products (which could require amendments to sales processes, withdrawal of products or the provision of restitution to affected customers, all of which may require additional provisions in the Group's financial accounts), poor governance of colleagues' incentives and rewards and approval of schemes which drive unfair customer outcomes. These can lead to remediation and regulatory intervention/enforcement (including fines). Ineffective management and oversight of legacy conduct issues can result in customers who are undergoing remediation being unfairly treated and therefore further rectification being required. The Group is also exposed to the risk of engaging in conduct which disrupts the fair and effective operation of a market in which it is active.

While the Group has implemented a number of policies in order to help mitigate against these risks, no assurance can be given that the conduct strategy and framework will be effective and will not have an adverse effect on the Group's results of operations, financial condition or prospects.

## REGULATORY AND LEGAL RISKS

**The Group and its businesses are subject to substantial regulation and oversight. Adverse legal or regulatory developments could have a significant material adverse effect on the Group's business, results of operations, financial condition or prospects.**

The Group and its businesses are subject to legislation, regulation, court proceedings, policies and voluntary codes of practice including the effects of any changes in these or the interpretation of them in the UK, the EU and the other markets in which the Group operates. The Group is therefore subject to associated legal and regulatory risks, including risk in connection with legal and regulatory actions and market reviews. Depending on the specific nature of the requirements and how they are enforced, they could have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

These laws and regulations include (i) increased regulatory oversight, particularly in respect of conduct issues, (ii) prudential regulatory developments, including ring-fencing, (iii) increased legislative requirements including the recently implemented Senior Managers and Certification Regime (the "SMCR"), and (iv) other industry-wide initiatives.

Unfavourable developments across any of these areas, discussed in greater detail elsewhere herein, could materially affect the Group's ability to maintain appropriate liquidity, increase its funding costs, constrain the operation of its business and/or have a material adverse effect on the Group's business, results of operations and financial condition. Areas where these changes could have an adverse effect on the Group include, but are not limited to:

- (i) general changes in government, central bank or regulatory policy, or changes in regulatory regimes that may influence investor decisions in particular markets in which the Group operates, any of which may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;
- (ii) external bodies applying or interpreting standards, laws, regulations or contracts differently to the Group;
- (iii) an uncertain and rapidly evolving prudential regulatory environment which could materially adversely affect the Group's ability to maintain liquidity and increase its funding costs;
- (iv) changes in competitive and pricing environments, including markets investigations, or one or more of the Group's regulators intervening to mandate the pricing of the Group's products, as a consumer protection measure;
- (v) one or more of the Group's regulators intervening to prevent or delay the launch of a product or service, or prohibiting an existing product or service;
- (vi) further requirements relating to financial reporting, corporate governance, corporate structure and conduct of business and employee compensation;
- (vii) expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership;
- (viii) changes to regulation and legislation relating to economic and trading sanctions, money laundering and terrorist financing; and
- (ix) regulatory changes which influence business strategy, particularly the rate of growth of the business, or which impose conditions on the sales and servicing of products, which have the effect of making such products unprofitable or unattractive to sell.

With respect to the State Aid commitments agreed with the European Commission by the Group under the State Aid regime in 2009, the Group has satisfied all material structural and behavioural commitments following the successful carve-out and disposal of TSB and non-core asset reductions. The Group is therefore no longer subject to restrictive behavioural commitments including the constraint on acquisitions, but the Group continues to be bound by two remaining limited ancillary commitments which means that the Group remains subject to supervision by the European Commission with respect to these commitments until they cease to have effect on or before June 2017.

For more detail on the changing prudential regulatory environment see “—Regulatory and legal risks—The Group faces risks associated with an uncertain and rapidly evolving international prudential, legal and regulatory environment” below.

**The Group faces risks associated with an uncertain and rapidly evolving international prudential, legal and regulatory environment.**

The Group's borrowing costs and access to capital markets, as well as its ability to lend or carry out certain aspects of its business, could be affected by prudential regulatory developments, including (i) amendments to FSMA introduced by the Financial Services (Banking Reform) Act 2013 (the “**Banking Reform Act**”) along with secondary legislation



and PRA/FCA rules made under the Banking Reform Act, (ii) amendments to the EU legislation comprising the Capital Requirements Directive and the Capital Requirements Regulation (together, “**CRD IV**”), or implementation of CRD IV in the UK, (iii) evolving European and global prudential and regulatory changes, and (iv) regulatory changes in the US.

## BANKING REFORM ACT

The Banking Reform Act’s measures contain provisions with respect to, amongst other things (i) ring-fencing domestic retail banking services of UK banks, and (ii) the implementation of SMCR.

199

## RISK FACTORS

### *RING-FENCING*

The Banking Reform Act, secondary legislation and PRA/FCA rules made under the FSMA have enacted amendments to the FSMA and the UK regulatory regime that require UK banking groups (such as the Group) with more than £25 billion (on a Group-wide basis) of core deposits (defined as “ring-fenced bodies” or “RFBs”) to separate the retail banking activities of their UK banks – particularly deposit-taking and associated services – from certain prohibited forms of activity, including (i) dealing in investments, (ii) incurring exposures to relevant financial institutions (which include, amongst others, credit institutions (other than RFBs), investment firms and alternative investment funds (subject to certain limited exceptions)), (iii) participating in an inter-bank payment system other than as a direct member (subject to certain limited exceptions), and (iv) having non-EEA branches or subsidiaries. RFBs are also subject to regulations governing how pension arrangements can be managed, following the implementation of ring-fencing.

The PRA and FCA are required by the Banking Reform Act to implement ring-fencing rules (the “Ring-fencing Rules”) by 1 January 2019, with the deadline for implementing changes to the Group’s pension scheme being 1 January 2026. The PRA has published consultation papers covering: (i) the legal structure of an RFB and its wider group, (ii) the governance arrangements for an RFB, (iii) the continuity of services and facilities, (iv) prudential requirements applicable to the RFB sub-group, (v) intra-group arrangements, (vi) the use of financial market infrastructure by RFBs, and (vii) reporting requirements regarding compliance with the ring-fencing regime, including an RFB’s reliance on any exemptions to the excluded activities and prohibitions under secondary legislation. RFBs are able to apply for waivers of the Ring-fencing Rules in accordance with the statutory procedure for waivers set out in FSMA. In July 2016, the PRA published its final policy statement, supervisory statement and rules covering items (i) through (vi) above, and the consultation process for item (vii) above has now closed. The PRA and FCA have also been granted powers under the FSMA to impose certain restructuring requirements on RFBs, their parent undertakings and certain other regulated entities within an RFB’s group if, in broad terms, the financial stability of the RFB is deemed to be at risk as a result of the implementation of the Ring-Fencing Rules within the relevant banking group.

Whilst the Ring-fencing Rules and other aspects of regulatory guidance are not yet in final form, the implementation of the Ring-fencing Rules will have an impact on the Group’s structure, governance arrangements, business and reporting models, operations, costs and financing arrangements.

The Group is actively engaged with HM Treasury, the PRA and FCA to ensure that it is able to fully implement the restructuring required to implement ring-fencing by the January 2019 deadline. As required under the PRA’s second consultation paper, the Group submitted its latest implementation plan to the PRA and FCA in December 2016. In addition, the Group will become subject to the expanded oversight powers granted to HM Treasury, the PRA and the FCA under the Banking Reform Act from 1 January 2019.

*SENIOR MANAGERS AND CERTIFICATION REGIME*

The SMCR is a recently implemented regime which came into force on 7 March 2016 and replaces the approved persons regime for deposit takers and other PRA designated firms. The SMCR comprises a number of elements, including the senior managers' regime, the certification regime and the conduct rules, which are due to be expanded by changes proposed by the Bank of England and the Financial Services Act 2016. The Group could be exposed to additional risk or loss if it is unable to comply with the requirements arising from the SMCR or if doing so imposes significant demands on the attention of management.

**CAPITAL REQUIREMENTS REGULATION AND CAPITAL REQUIREMENTS DIRECTIVE**

In 2012, the Basel Committee on Banking Supervision (the "Basel Committee") approved significant changes to the regulatory framework applicable to the Group, including new capital and liquidity requirements intended to reinforce capital standards and to establish minimum liquidity standards for credit institutions (such changes being commonly referred to as "Basel III"). The Basel III changes refer to, among other things, (i) new requirements for a bank's capital base; (ii) measures to strengthen capital requirements for counterparty credit exposures arising from certain transactions; (iii) the introduction of a leverage ratio; and (iv) short-term and longer-term standards for funding and liquidity.

The Basel III reform package has been implemented in Europe through CRD IV. Full implementation began from 1 January 2014, with particular elements being phased in over a period of time, to be fully effective by 2024.

As a European regulation, the Capital Requirements Regulation is directly applicable in the UK and the Group is subject to its requirements. In December 2013, the PRA published its principal statement of policy, setting out the PRA rules in order to implement the Capital Requirements Directive in the UK.

The CRD IV regime is expected to continue to evolve as a result of further changes agreed by EU legislators, binding regulatory technical standards and guidelines to be developed by the European Banking Authority (EBA) and changes to the way in which the PRA interprets and applies these requirements to UK financial institutions. In particular, on 23 November 2016, the European Commission put forward significant proposals to amend, among other things, both the Capital Requirements Regulation and the Capital Requirements Directive (such amended Capital Requirements Regulation to be known as "CRR 2" and the Capital Requirements Directive as "CRD V"), including to propose a binding leverage ratio, a binding net stable funding ratio, more risk-sensitive capital requirements. If adopted, these reforms are expected to enter into force by 2019 at the earliest.

CRD IV introduced a number of new capital buffers to provide further capital cushions for additional risks that financial institutions may be subject to. These buffers will be fully phased in by 1 January 2019 and comprise: (i) a

capital conservation buffer; (ii) a time-varying countercyclical capital buffer; (iii) buffers applicable to global systemically important banks (G-SIBs); (iv) buffers applicable to other systematically important banks; and (v) a systemic risk buffer (SRB).

The Group is not currently categorised as a G-SIB for which the Financial Stability Board (FSB) has set buffer rates. The Bank of England's Financial Policy Committee (FPC) published the final framework for the UK SRB in May 2016 and the PRA published their statement of policy on their approach for implementing the SRB in December 2016. The Group's RFB sub-group will be subject to the UK SRB from 1 January 2019; however, the level of the buffer will be dependent on the final structure of the Group's RFB sub-group (which is, in turn, due to be finalised prior to 1 January 2019).

In December 2015, the FPC released a supplement to its Financial Stability Report on the framework of capital requirements for UK banks. The supplement outlined the FPC's final views on the overall calibration of the UK capital framework and described how the framework of capital requirements for UK banks is expected to transition from its current state to its end point in 2019, as well as ongoing work to refine requirements during that transition period. In this supplement, the FPC set out its strategy for the time-varying UK countercyclical capital buffer which will be applied to a bank's UK exposures. The UK countercyclical capital buffer rate was set to increase from 0 per cent. to 0.5 per cent. of risk-weighted assets on 29 March 2017, at which time the overlapping aspects of Pillar 2 supervisory capital buffers would be removed or reduced. However, following the EU referendum, on 5 July 2016 the FPC announced in their Financial Stability Report that the planned 0.5 per cent. UK countercyclical capital buffer would not be implemented in March 2017 and the 0 per cent. rate was expected to remain until at least June 2017. The FPC also recommended that where existing

## RISK FACTORS

Pillar 2 PRA supervisory buffers reflect risks that would be captured by a UK countercyclical capital buffer rate, the PRA should reduce those buffers by an amount of capital which is equivalent to the effect of a UK countercyclical capital buffer rate of 0.5 per cent. The FPC has also indicated that it expects to review the countercyclical buffer and to set a UK countercyclical capital buffer rate in the region of 1 per cent. of risk-weighted assets when risks are judged to be neither subdued nor elevated, but the rate can be set in excess of this level. There remains a risk that any future changes to the countercyclical capital buffer rate in the UK could lead to an increase in capital requirements applicable to the Group where these changes are deemed not to be already captured by Pillar 2 supervisory capital buffers.

Under the Capital Requirements Directive Article 141, institutions that fail to meet their “combined buffer requirements” (consisting of buffers (i), (ii), and the higher of (iii), (iv) and (v)) will be subject to restrictions on the making of certain discretionary payments (including dividends on ordinary shares, coupons or Additional Tier 1 (AT1) securities and certain items of variable remuneration). These restrictions are scaled according to the extent of the breach and result in a maximum distributable amount which may be expended on such discretionary payments in each relevant period.

As outlined above, the Group’s capital buffer requirements are still being finalised and investors may not be able to predict accurately the risk of dividends on ordinary shares or distributions on other securities being prohibited or restricted as a result of the Capital Requirements Directive Article 141.

The FPC supplement also sets out how the PRA intends to set a PRA buffer for individual banks which is the minimum level of capital buffer required by the PRA. The PRA buffer is confidential between the Group and the PRA and can be set at a level in excess of the combined buffer requirements and any further sectoral capital measures that the PRA has imposed. As a result, investors may not be able to predict accurately the risk of dividends on ordinary shares or distributions on other securities being restricted as a result of the PRA buffer.

In addition to the risk based capital framework, the Group is also subject to minimum requirements under the UK leverage framework. Currently, the UK leverage ratio framework does not give rise to higher capital requirements for the Group than the risk-based capital framework but there is a risk that it could do so as a result of a change in the Group’s financial position or a strengthening of the regulatory requirements (which are expected to be calibrated in 2017).

The Group will monitor the ongoing changes to the capital framework which may affect the Group’s financial position or require the strengthening of regulatory requirements.

## EVOLVING EUROPEAN AND GLOBAL PRUDENTIAL AND REGULATORY CHANGES

More generally and in the longer term, the Basel Committee is considering revisions to Basel III including: credit risk capital requirements; capital floors; operational risk capital requirements; and capital requirements covering credit valuation adjustments. Whilst the Basel Committee and the PRA have publicly stated that they are not seeking to increase the overall quantum of capital in the system, there is a risk that individual firms may be more impacted than others, or the final rules are more onerous than these statements suggest. Final rules are expected to be published by the Basel Committee in early 2017 and until such rules are published and translated into European legislation it will remain premature to estimate the impact.

The Minimum Requirement for Own Funds and Eligible Liabilities (MREL), which is being implemented in the EU and the UK, will apply to EU financial institutions and cover capital and debt instruments that are capable of being written-down or converted to equity in order to prevent a financial institution from failing in a crisis. In November 2016, the Bank of England published a statement of policy outlining its approach to setting MREL. The Bank of England has set a final MREL conformance date of 1 January 2022 with MREL requirements transitioning up to that date. The PRA has also separately stated that financial institutions should expect the PRA to investigate whether any financial institution in breach of its MREL requirement is failing, or likely to fail, to satisfy the threshold conditions for authorisation, with a view to taking further action as necessary. On 23 November 2016, the European Commission published proposals to amend the BRRD to implement, among other things, a revised firm-specific MREL requirement. If adopted, these reforms are expected to enter into force by 2019 at the earliest. Under CRD V, it is proposed that MREL will also be factored in to the calculation of the maximum distributable amount (as discussed above). There is a risk that conforming with the final MREL requirements may create an unexpected adverse impact upon the amount, mix and associated cost of the Group's capital and eligible debt of the Group.

Following the report of the European Commission's high-level expert group on banking structural reform chaired by Erkki Liikanen (the "Liikanen Report"), published in 2012, structural reform measures that are similar to some of those contained in the Banking Reform Act are also under consideration.

European Regulation 648/2012, known as the European Market Infrastructure Regulation (EMIR), introduces new requirements to improve transparency and reduce the risks associated with the derivatives market. EMIR came into force on 16 August 2012 and when it fully comes into effect, EMIR will require entities that enter into any form of derivative contract, including interest rate, foreign exchange, equity, credit and commodity derivatives, to: (i) report every derivative contract entered into to a trade repository, (ii) implement new risk management standards (including operational processes and margining) for all bilateral OTC derivative trades that are not cleared by a central counterparty, and (iii) clear, through a central counterparty, OTC derivatives that are subject to a mandatory clearing obligation. Certain of the requirements under EMIR (such as some clearing requirements) have yet to fully come into effect. The first clearing obligations for certain interest rate derivatives have applied from June 2016. Variation margin requirements for uncleared trades came into effect on 4 February 2017 for market participants with a sufficiently large derivative trading volume and on 1 March 2017 for all other counterparties, including the Group. Certain products are exempt from variation margin requirements at this time and implementation for these products is due to be phased in. The Group does not expect initial margin requirements to apply to it until September 2018. It is expected that there will be additional costs and limitations on the Group's business resulting from these requirements.

The Group's businesses could be adversely impacted by significant US regulatory reforms including any changes relating to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which provides a broad framework for significant regulatory changes. For example, final rules implementing the "Volcker Rule" came into effect in July 2015, prohibiting certain types of proprietary trading by the Group and limiting the Group's ability to make investments in and sponsor certain private equity funds and hedge funds. In addition, the Dodd-Frank Act's implementing regulations include final rules imposing registration and other requirements on entities that engage in derivatives activities. The new US administration has announced its intention to modify the existing regulatory framework, including the Dodd-Frank Act. Although the timing and scope of any such changes and/or further progress on the Dodd-Frank Act's implementing regulations are uncertain, there have been and will continue to be additional costs and/or limitations on the Group's businesses in connection with any US financial regulatory changes.

## RISK FACTORS

The full impact of the derivative market regulations on the Group remains unclear, and could have a materially adverse effect on the Group's business, results of operations, financial condition or prospects. In particular, the costs of complying with the regulations are expected to be burdensome, giving rise to additional expenses that may have an adverse impact on the Group's financial condition. Additionally, such regulations could make it more difficult and expensive to conduct hedging and trading activities. As a result of these increased costs, the regulation of the derivative markets may also result in the Group deciding to reduce its activity in these markets.

It is difficult to predict how and in what final form many of the regulatory changes described herein will be implemented and what financial obligations may be imposed in relation thereto. While the Group continues to work closely with regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes, the Group could be exposed to additional risk of loss if it is unable to comply with the requirements arising from these regulations or if doing so imposes significant demands on the attention of management. Depending on the specific nature of the requirements and how they are enforced, such changes could have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements including changes to how the Group and its businesses are capitalised and funded, distribution of capital, reducing weighted assets, modifying legal entity structure and changing the Group's business mix to strengthen the Group's capital position.

### **The Group and its UK subsidiaries may become subject to the provisions of the Banking Act 2009, as amended, which could have an adverse impact on the Group's business.**

Under the Banking Act 2009, as amended, (the "Banking Act"), substantial powers have been granted to HM Treasury, the Bank of England and the PRA and FCA (together, the "Authorities") as part of the special resolution regime (the "SRR"). These powers enable the Authorities to deal with and stabilise UK-incorporated institutions with permission to accept deposits pursuant to Part 4A of the FSMA if they are failing or are likely to fail to satisfy certain threshold conditions (within the meaning of Section 55B of the FSMA). The SRR consists of five stabilisation options: (i) transfer of all or part of the business of the relevant entity or the shares of the relevant entity to a private sector purchaser, (ii) transfer of all or part of the business of the relevant entity to a "bridge bank" established and wholly owned by the Bank of England, (iii) transfer all or part of the relevant entity or "bridge bank" to an asset management vehicle, (iv) making of one or more resolution instruments by the Bank of England, and (v) temporary public ownership of the relevant entity. HM Treasury may also take a parent company of a relevant entity into temporary public ownership where certain conditions are met. The SRR also provides for two new insolvency and administration procedures for relevant entities. Certain ancillary powers include the power to modify certain contractual arrangements in certain circumstances.

In addition, the Group's costs of doing business may increase by amendments made to the Banking Act in relation to deposits covered by the UK Financial Services Compensation Scheme (the "FSCS"). The Group contributes to compensation schemes such as the FSCS in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers. Further provisions in respect of these costs are likely to be necessary in the future. The ultimate cost to the industry, which will also include the cost of any compensation payments made by the FSCS and, if necessary, the cost of meeting any shortfall after recoveries on the borrowings entered into by the



FSCS, remains uncertain but may be significant and may have a material effect on the Group's business, results of operations or financial condition.

The final text of the EU Directive 2014/59/EU establishing an EU-wide framework for the recovery and resolution of credit institutions and investment firms (the "BRRD"), entered into force on 2 July 2014 and in the UK, the Banking Reform Act made provision for certain aspects of the "bail-in" power. Certain amendments to the BRRD may be made as a result of proposals published by the European Commission on 23 November 2016. Under the "bail-in" power, prior to insolvency proceedings, regulators would have the power to impose losses on holders of regulatory capital securities, senior bondholders and/or other creditors while potentially leaving untouched certain other classes of excluded creditors; generally losses are to be taken in accordance with the priority of claims under normal insolvency proceedings. Bail-in is expected to apply to all of the Group's unsecured senior and subordinated debt instruments with a remaining maturity of greater than seven days. The stated aim of the BRRD is to provide authorities designated by EU member states to apply the resolution tools and exercise the resolution powers set forth in the BRRD (the "resolution authorities") with common tools and powers to address banking crises pre-emptively in order to safeguard financial stability and minimise taxpayers' exposure to losses. The powers granted to resolution authorities under the BRRD include, but are not limited to: (i) a "write-down and conversion power" relating to Tier 1 and Tier 2 capital instruments and (ii) a "bail-in" power relating to eligible liabilities (including the capital instruments and senior debt securities issued by the Group). Such powers give resolution authorities the ability to write-down or write-off all or a portion of the claims of certain unsecured creditors of a failing institution or group and/or to convert certain debt claims into another security, including ordinary shares of the surviving group entity, if any. Such resulting ordinary shares may be subject to severe dilution, transfer for no consideration, write-down or write-off. Such powers were implemented in the UK with effect from 1 January 2015.

The conditions for use of the bail-in power are, in summary, that (i) the regulator determines that the bank is failing or likely to fail, (ii) having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank to avoid the failure of the bank, (iii) the relevant UK resolution authority determines that it is necessary having regard to the public interest to exercise the bail-in power in the advancement of one of the statutory objectives of resolution, and (iv) one or more of those objectives would not be met to the same extent by the winding up of the bank. The Banking Act and secondary legislation made thereunder provides certain other limited safeguards for creditors in specific circumstances. The "no creditor worse off" safeguard contained in the Banking Act may not apply in relation to an application of the write-down and conversion power in circumstances where a stabilisation power is not also used; holders of debt instruments which are subject to the power may, however, have ordinary shares transferred to or issued to them by way of compensation. The exercise of mandatory write-down and conversion power under the Banking Act or any suggestion of such exercise could, therefore, materially adversely affect the rights of the holders of equity and debt securities and the price or value of their investment and/or the ability of the Group to satisfy its obligations under such debt securities.

In addition to the provisions described above, it is possible that the exercise of other powers under the Banking Act to resolve failing banks in the UK and give the authorities powers to amend the terms of contracts (for example, varying the maturity of a debt instrument) and to override events of default or termination rights that might be invoked as a result of the exercise of the resolution powers could have a material adverse effect on the rights of holders of the equity and debt securities issued by the Group, including through a material adverse effect on the price of such securities. The Banking Act also gives the Bank of England the power to override, vary or impose contractual obligations between a UK bank, its holding company and its group undertakings for reasonable consideration, in order to enable any transferee or successor bank to operate effectively. There is also power for HM Treasury to amend the

law (excluding provisions made by or under the Banking Act) for the purpose of enabling it to use the regime powers effectively, potentially with retrospective effect.

The determination that securities and other obligations issued by the Group will be subject to write-down, conversion or bail-in is likely to be inherently unpredictable and may depend on a number of factors which may be outside of the Group's control. This determination will also be made by the

202

## RISK FACTORS

relevant UK resolution authority and there may be many factors, including factors not directly related to the Company or the Group, which could result in such a determination. Because of this inherent uncertainty and given that both BRRD and the relevant provisions of the Banking Act remain untested in practice, it will be difficult to predict when, if at all, the exercise of a bail-in power may occur which would result in a principal write-off or conversion to other securities, including the ordinary shares of the Company. Moreover, as the criteria that the relevant UK resolution authority will be obliged to consider in exercising any bail-in power provide it with considerable discretion, holders of the securities issued by the Group may not be able to refer to publicly available criteria in order to anticipate a potential exercise of any such power and consequently its potential effect on the Group and the securities issued by the Group.

Potential investors in the securities issued by the Group should consider the risk that a holder may lose all of its investment, including the principal amount plus any accrued interest, if such statutory loss absorption measures are acted upon. The BRRD and applicable state aid rules provide that, other than in certain limited circumstances set out in the BRRD, extraordinary governmental financial support will only be available to the Group as a last resort once the write down and conversion powers and resolution tools referred to above have been exploited to the maximum extent possible.

Holders of the Group's securities may have limited rights or no rights to challenge any decision of the relevant UK resolution authority to exercise the UK bail-in power or to have that decision reviewed by a judicial or administrative process or otherwise. Accordingly, trading behaviour in respect of such securities is not necessarily expected to follow the trading behaviour associated with other types of securities that are not subject to such recovery and resolution powers. Potential investors in securities issued by the Group should consider the risk that a holder of such securities may lose all of its investment, including (in the case of debt securities) the principal amount plus any accrued and unpaid interest, if such statutory loss absorption measures are acted upon or if that senior debt instrument may be converted into Lloyds Banking Group plc ordinary shares. Further, the introduction or amendment of such recovery and resolution powers, and/or any implication or anticipation that they may be used, may have a significant adverse effect on the market price of such securities, even if such powers are not used.

### **The Group faces risks associated with its compliance with a wide range of laws and regulations.**

The Group is exposed to various forms of legal and regulatory risk, including:

- (i) certain aspects of the Group's activities and business may be determined by the relevant authorities, the Financial Ombudsman Service (the "FOS") or the courts not to have been conducted in accordance with applicable laws or regulations, or, in the case of the FOS, with what is fair and reasonable in the Ombudsman's opinion;
- (ii) the possibility of alleged mis-selling of financial products or the mishandling of complaints related to the sale of such products by or attributed to a member of the Group, resulting in disciplinary action or requirements to amend sales processes, withdraw products, or provide restitution to affected customers, all of which may require

additional provisions;

- (iii) risks relating to compliance with, or enforcement actions in respect of, existing and/or new regulatory or reporting requirements, including as a result of a change in focus of regulation or a transfer of responsibility for regulating certain aspects of the Group's activities and business to other regulatory bodies;
- (iv) contractual and other obligations may either not be enforceable as intended or may be enforced against the Group in an adverse way;
- (v) the intellectual property of the Group (such as trade names) may not be adequately protected;
- (vi) the Group may be liable for damages to third parties harmed by the conduct of its business;
- (vii) the risk of regulatory proceedings, enforcement actions and/or private litigation, arising out of regulatory investigations or otherwise (brought by individuals or groups of plaintiffs) in the UK and other jurisdictions; and
- (viii) risks related to court or UK Government activity leading to a requirement to equalise pension benefits for the effect of Guaranteed Minimum Pensions, in particular following the completion of the recent consultation by the Department for Work and Pensions on a possible methodology for delivering equalisation. It is possible that any such requirement could increase liabilities in the Group's defined benefit pension schemes.

Regulatory and legal actions pose a number of risks to the Group, including substantial monetary damages or fines, the amounts of which are difficult to predict and may exceed the amount of provisions set aside to cover such risks. In addition, the Group may be subject, including as a result of regulatory actions, to other penalties and injunctive relief, civil or private litigation arising out of a regulatory investigation or otherwise, the potential for criminal prosecution in certain circumstances and regulatory restrictions on the Group's business, all of which can have a negative effect on the Group's reputation. Any of these risks could have an adverse impact on the Group's operations, financial condition, results of operations or prospects and the confidence of customers in the Group, as well as taking a significant amount of management time and resources away from the implementation of the Group's strategy.

The Group's operations also expose it to various forms of reputational impacts. Negative public opinion can result from the actual or perceived manner in which the Group conducts its business activities, from the Group's financial performance, the level of direct and indirect government support, actual or perceived practices in the banking and financial industry, or allegations of misconduct. Negative public opinion may adversely affect the Group's ability to keep and attract customers, which may result in a material adverse effect on the Group's financial condition, results of operations or prospects. Negative public opinion referenced in the media as "lack of trust" in banking can be impacted by actions of competitors across the industry as well as actions by the Group. Regaining the trust of customers and the public is a key objective of the Group.

The Group may settle litigation or regulatory proceedings prior to a final judgment or determination of liability to avoid the cost, management efforts or negative business, regulatory or reputational consequences of continuing to contest liability, even when the Group believes that it has no liability or when the potential consequences of failing to prevail would be disproportionate to the costs of settlement. Furthermore, the Group may, for similar reasons, reimburse counterparties for their losses even in situations where the Group does not believe that it is legally compelled to do so. Failure to manage these risks adequately could materially affect the Group, both financially and reputationally.

**The Group faces risks associated with the high level of scrutiny of the treatment of customers by financial institutions from regulatory bodies, the media and politicians.**

The Group's operations, in particular related to its treatment of customers, are subject to supervision by the FCA and other regulatory authorities. In recent periods, the UK banking industry has been subject to heightened attention from these regulatory authorities, as well as the press and the UK Government. The FCA in particular continues to focus on conduct of business issues through its supervision activities and its establishment of a new

203

## RISK FACTORS

payment systems regulator (Payment Systems Regulator). Other regulatory efforts include the implementation of the UK Mortgage Market Review (MMR) in April 2014, which requires lenders to obtain evidence of borrowers' income so as to ensure that they can afford a mortgage, including with respect to potential interest rate rises. The Bank of England is currently implementing limitations on the ability of lenders to provide high loan-to-income mortgages. Increased scrutiny or regulatory development in these areas could materially affect the Group's operation of its business and/or have a material adverse effect on the Group's business, results of operations or financial condition. Alongside these changes, the FCA may consider various adjustments to the MMR or other legislation in order to align it with the Mortgage Credit Directive 2014/17/EU (MCD), which came into force on 21 March 2016, including: (i) introducing the "European Standardised Information Sheet", which is a new product disclosure document to be provided to customers, (ii) requiring firms to calculate both an annual percentage rate of charge (APRC) according to the method set out in the MCD as well as a second APRC for variable-rate mortgage products, and (iii) widening the scope of UK mortgage regulation to include properties located across the EEA, as well as certain buy-to-let mortgages and second charge lending.

Additionally, the Group is subject to the Markets in Financial Instruments Directive (MiFID) and its various implementing measures, which together regulate the provision of "investment services and activities" in relation to a range of customer-related areas, including customer classification, conflicts of interest, client order handling, investment research and financial analysis, suitability and appropriateness, transparency obligations and transaction reporting. MiFID is in the process of being replaced by a revised directive (MiFID II) and a new regulation (Markets in Financial Instruments Regulation or "MiFIR"), which entered into force on 2 July 2014. The changes to MiFID include expanded supervisory powers that include the ability to ban specific products, services or practices. While the majority of the provisions of MiFID II and MiFIR and the implementing laws and regulations are currently scheduled to apply from 3 January 2018, the Group has commenced work to meet anticipated requirements. If the Group incurs substantial expenses associated with compliance, ongoing compliance imposes significant demands on the attention of management that result in other areas of the Group's business not receiving sufficient management attention, or if particular products, services or practices are banned, the Group's results of operations could be materially adversely affected.

The Group is also subject to European regulation on customer deposits. On 12 June 2014, the Deposit Guarantee Schemes Directive 2014/49/EU (the "recast DGSD") was published in the Official Journal of the EU, which replaced Directive 94/19/EC on Deposit Guarantee Schemes. As required by the recast DGSD, the UK introduced a compliant deposit guarantee scheme (DGS) that:

- gives a preference in liquidation or resolution to deposits made by retail customers and SMEs over other senior creditors (including the holders of the Notes issued by the Bank);
- sets out the rights of eligible depositors (typically retail customers) to compensation, and repayment circumstances and procedures by the DGS, covering the unavailability of any deposit, up to aggregate deposits of €100,000;
- places obligations on credit institutions, in particular, requirements to provide specified information to depositors (and potential depositors) on their rights to compensation under the DGS; and

sets out provisions on the financing of DGSs, including target funding levels and contribution amounts by credit institutions.

In addition, increasing regulatory scrutiny under the EU General Data Protection Regulation may limit the extent to which customer data can be used to support the Group achieving its strategic objectives.

**The financial impact of legal proceedings and regulatory risks might be material but is difficult to quantify. Amounts eventually paid may materially exceed the amount of provisions set aside to cover such risks, or existing provisions may need to be materially increased in response to changing circumstances, as has been the case in respect of payment protection insurance (“PPI”) redress payments.**

Where provisions have already been taken in published financial statements of the Group or results announcements for ongoing legal or regulatory matters, these have been recognised, in accordance with IAS 37 (“Provisions, Contingent Liabilities and Contingent Assets”), as the best estimate of the expenditure required to settle the obligation as at the reporting date. Such estimates are inherently uncertain and it is possible that the eventual outcomes may differ materially from current estimates, resulting in future increases or decreases to the required provisions, or actual losses that exceed or fall short of the provisions taken.

The Group increased provisions for expected PPI costs by a further £1.35 billion in 2016. This brings the total amount provided for at the end of 2016 to £17.4 billion, of which £2.6 billion remains unutilised relating to complaints and administration costs. Provisions have not been taken where no obligation (as defined in IAS 37 (“Provisions, Contingent Liabilities and Contingent Assets”)) has been established, whether associated with a known or potential future litigation or regulatory matter. Accordingly, an adverse decision in any such matters could result in significant losses to the Group which have not been provided for. Such losses would have an adverse impact on the Group’s financial condition and operations.

In November 2014, the UK Supreme Court ruled in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 (Plevin) that failure to disclose to a customer a “high” commission payment on a single premium PPI policy sold with a consumer credit agreement created an unfair relationship between the lender and the borrower under s140 of the Consumer Credit Act 1974. It did not define a tipping point above which commission was deemed “high”. The disclosure of commission was not a requirement of the FSA’s (now FCA’s) Insurance: Conduct of Business sourcebook rules for the sale of general insurance (including PPI). The industry, the FCA and the FOS are considering the broader impacts of this decision. Permission to appeal the redress outcome in the Plevin case was refused by the Court of Appeal in July 2015 and by the President of the Family Division in November 2015.

In November 2015 and August 2016, the FCA consulted on the introduction of a two year industry deadline by which consumers would need to make their PPI complaints or lose their right to have them assessed, and proposed rules and guidance about how firms should handle PPI complaints fairly in light of the Plevin judgement discussed above. On 2 March 2017 the FCA confirmed the deadline would be 29 August 2019, and new rules for Plevin would start in August 2017. The industry deadline applies to the handling of these complaints. It is anticipated that the introduction of an industry deadline could encourage eligible consumers to bring their claims earlier than would have otherwise

been expected during such period in the absence of an industry deadline for having complaints assessed. The new rules could have a material adverse effect on the Group's reputation, business, financial condition, results of operations and prospects.

204



## RISK FACTORS

### BUSINESS AND ECONOMIC RISKS

**The Group's businesses are subject to inherent and indirect risks arising from general macro-economic conditions in the UK, the US, the Eurozone, Asia and globally, and any resulting instability of financial markets or banking systems.**

The Group's businesses are subject to inherent and indirect risks arising from general and sector-specific economic conditions in the markets in which it operates, particularly the UK, where the Group's earnings are predominantly generated and the Group's operations are increasingly concentrated following the strategic reduction of its international presence. The Group may have credit exposure in countries outside the UK even if it does not have a presence in such countries. Any significant macro-economic deterioration in the UK and/or other economies could have a material adverse effect on the results of operations, financial condition or prospects of the Group, as could continued or increasing political uncertainty within the UK and the EU. The profitability of the Group's businesses could be affected by market factors such as the deterioration of UK economic growth significantly below long-term average levels, rising unemployment, reduced corporate profitability, reduced personal income levels (in real terms), inflationary pressures, including those arising from the sterling's depreciation, reduced UK Government and/or consumer expenditure, changes in interest rates (and the timing, quantum and pace of those changes as well as the possibility of further reductions in interest rates, including negative interest rates or of unexpected increases in interest rates which may have a detrimental effect on the Group's customers and their ability to service interest), increased personal, corporate or SME insolvency rates, borrowers' reduced ability to repay loans and increased tenant defaults which could cause prices of residential or commercial real estate or other asset prices to fall, thereby reducing the collateral value on many of the Group's assets, fluctuations in commodity prices, changes in foreign exchange rates; or a marked deterioration in global economic growth reflecting the high levels of debt that have built up in some emerging economies, most notably China. These, in turn, could cause increased impairments and/or fair value adjustments.

In addition to the possibility of macro-economic deterioration, any increase of financial market instability including any increase in credit spreads, increase or reduction in interest rates, including negative interest rates, and general illiquidity within the markets that the Group uses for hedging or bond issuances may represent further risk to the Group's business. The outlook for global growth remains uncertain due to issues such as geopolitical tensions (e.g. the Syrian crisis, EU difficulties in dealing with the large inflow of migrants, fallout from Ukraine/Russia and Middle Eastern instability), the impact of the recent US presidential election, continued divergence in economic performance between countries within the Eurozone, and the slow-down of economic growth rates in emerging markets generally and China in particular. The Group has significant exposures, particularly by way of loans, in a number of overseas jurisdictions and is therefore subject to various risks relating to the stability of these financial markets. The global financial system has suffered considerable turbulence and uncertainty in recent years and, despite recent growth in the Eurozone and other advanced economies, the outlook for the global economy over the near to medium term remains challenging.

In the Eurozone, the pace of economic recovery has lagged behind that of other advanced countries following the global recession. While economic growth has picked up in certain Eurozone countries over the past year, recovery

remains relatively weak and deflationary pressures, together with high levels of private and public debt, outstanding weaknesses in the financial sector and reform fatigue, also remain a concern. In addition, increased political uncertainty in the Eurozone, particularly in light of the upcoming elections in The Netherlands, France and Germany, could create financial instability and have a negative impact on the Eurozone and global economies. The possibility of prolonged low growth in the Eurozone could weaken the UK's economic prospects, given the extensive economic and financial linkages between the UK and the Eurozone.

The recent US presidential election result creates additional uncertainty for the US and global economic outlook. Whilst it is possible that the new administration's economic policies might have an adverse effect on US and global growth as well as global trade prospects, it is also possible that an expansionary fiscal policy could create greater than expected growth resulting in higher US inflation and interest rates which could in turn significantly impact global investor risk appetite, sparking elevated financial market volatility.

In addition, developing macro-economic uncertainty in emerging markets, in particular the high and growing level of debt in China and the risk of a sharp slowdown in Chinese economic growth or a devaluation of the Renminbi could pose threats to global economic recovery. External debt levels are higher now in emerging markets than before the global financial crisis, which could lead to higher levels of defaults and non-performing loans, in particular in an environment of rising interest rates. Financial markets may experience renewed periods of volatility, especially given the recent instability in oil and other commodity prices impacting corporates and emerging markets dependent on the oil and gas sector, creating the potential for a return of contagion between countries and banking systems which may place new strains on funding markets.

The Group has credit exposure to SMEs and corporates, financial institutions, sovereigns and securities which may have material direct and indirect exposures in Eurozone countries, the US and other countries. With the exception of the Group's retail lending exposures in the Republic of Ireland, its direct credit exposure to the peripheral Eurozone countries through sovereign and private sector exposure is relatively small and has been managed steadily downward since 2008.

Nonetheless, any default on the sovereign debt of these countries and the resulting impact on other Eurozone countries, including the potential that some countries could leave the Eurozone, could have a material adverse effect on the Group's business. The exit of any member state from the European Monetary Union (the "EMU") could result in deterioration in the economic and financial environment in the UK and the Eurozone that would materially affect the capital and the funding position of participants in the banking industry, including the Group. This could also give rise to operational disruptions to the Group's business.

Examples of indirect risks to the Group associated with the Eurozone which have been identified are adverse developments relating to: 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 and airlines known to operate in certain Eurozone countries, and international banks with custodian operations based in certain European locations. Adverse developments relating to these sectors, or banking groups could increase the risk of defaults and negatively impact the Group's business, results of operations or financial condition.

The effects on the UK, European and global economies of the exit of one or more EU member states from the EMU, or the redenomination of financial instruments from the Euro to a different currency, are extremely uncertain and very difficult to predict and protect fully against in view of: (i) the potential for economic and financial instability in the Eurozone and possibly in the UK, (ii) the lasting impact on governments' financial positions of the global financial crisis, (iii) the uncertain legal position, and (iv) the fact that many of the risks related to the business are totally, or in part, outside the control of the Group. However, if any such events were to occur, they may result in: (a) significant market dislocation, (b) heightened counterparty risk, (c) an adverse effect on the management of market risk and, in particular, asset and liability management due, in part, to redenomination of financial assets and liabilities, (d) an indirect risk of counterparty failure, or (e) further political uncertainty in the UK, any of which could have a material adverse effect on the results of operations, financial condition or prospects of the Group. Any adverse changes affecting the economies of the countries in which the Group has significant direct and indirect credit exposures, including those discussed above and any further deterioration in global macro-economic conditions, could have a material adverse effect on the Group's results of operations, financial condition or prospects.

## RISK FACTORS

### **Political, legal, regulatory, constitutional and economic uncertainty arising from the outcome of the referendum on the UK's membership of the European Union could adversely impact the Group's business, results of operations, financial condition and prospects.**

On 23 June 2016, the UK held a referendum on the UK's continued membership of the EU. A majority of voters voted for the UK to leave the EU. The announcement of the referendum result caused significant volatility in global stock markets and currency exchange rate fluctuations immediately following the EU referendum result that resulted in a significant weakening of the sterling against the U.S. dollar, the euro and other major currencies. The share prices of major UK banks and bank holding companies, including the Company, suffered significant declines in market prices immediately following the result of the referendum and major credit rating agencies downgraded the UK's sovereign credit rating.

A process of negotiation will be required to determine the future terms of the UK's relationship with the EU, and the uncertainty regarding the timing of, and the process for, the UK's exit from the EU before, during and after the period of negotiation could have a negative economic impact and result in further volatility in the markets which could in turn adversely impact the Group's business, results of operations, financial condition and prospects.

The effects on the UK, European and global economies of the uncertainties arising from the results of the referendum and the process of the UK's exit from the EU are difficult to predict but may include economic and financial instability in the UK, Europe and the global economy and the other types of risks described in "*—The Group's businesses are subject to inherent and indirect risks arising from general macro-economic conditions in the UK, the US, the Eurozone, Asia and globally, and any resulting instability of financial markets or banking systems*".

Under Article 50 of the Treaty on European Union (Article 50) once the exit process is triggered by the withdrawing member state, a two-year period of negotiation begins to determine the new terms of the withdrawing member's relationship with the EU, after which period its EU membership ceases unless the European Council, together with the withdrawing member, unanimously decides to extend this period.

If, as is expected, the UK invokes Article 50, negotiations relating to the terms of the UK's relationship with the EU may extend beyond the two-year period set forth therein which could create additional volatility in the markets and have an adverse impact on the Group's profitability. These negotiations will run in parallel to standalone bilateral negotiations with many individual countries and multilateral counterparties with which the UK currently has trading arrangements by virtue of its membership of the EU. The timing of, and process for, such negotiations and the resulting terms of the UK's future economic, trading and legal relationships are uncertain.

Furthermore, any uncertainty in the UK arising from the UK leaving the EU could be exacerbated should the possibility of a further Scottish independence referendum be resurrected. This could cause further uncertainty and

risks to the Group.

The longer term effects of the EU referendum are difficult to predict but could include further financial instability and slower economic growth, in the UK in particular, but also in Europe and the global economy. The possible policy of further decreases in interest rates by the Bank of England or sustained low or negative interest rates would put further pressure on the Group's interest margins and adversely affect the Group's profitability and prospects. Furthermore, such market conditions may also result in an increase in the Group's pension deficit.

A challenging macroeconomic environment, reduced profitability and greater market uncertainty could negatively impact the Group's performance and potentially lead to credit ratings downgrades which could adversely impact the Group's ability to access funding and the cost of such funding. The Group's ability to access capital markets on acceptable terms and hence its ability to raise the amount of capital and funding required to meet its regulatory requirements and targets, including those relating to loss-absorbing instruments to be issued by the Group, could be affected.

The Group is subject to substantial EU-derived laws, regulation and oversight. There is now significant uncertainty as to the respective legal and regulatory environments in which the Group and its subsidiaries will operate when the UK is no longer a member of the EU. In particular, the Group and its counterparties may no longer be able to rely on the European passporting framework for financial services, which could result in the loss of customers and/or the requirement for the Group to apply for authorisation in multiple EU jurisdictions, the costs, timing and viability of which are uncertain. This uncertainty, and any actions taken as a result of this uncertainty (such as corporate clients of the Group preferring to transact with European competitors or to relocate from the UK to the EU to avoid a loss of passporting rights), as well as new or amended legislation and regulation, may have a significant impact on the Group's operations, profitability and business model. For further information on the Group's regulatory and legal risks see "*—Regulatory and legal risks*".

**Any tightening of monetary policy in jurisdictions in which the Group operates could affect the financial condition of its customers, clients and counterparties, including governments and other financial institutions, which could in turn adversely affect the Group's results of operations.**

Quantitative easing measures implemented by major central banks, adopted alongside record low interest rates to support recovery from the global financial crisis, have arguably helped loosen financial conditions and reduce borrowing costs. These measures may have led to the emergence of asset and liquidity bubbles that are vulnerable to rapid price corrections as financial conditions tighten, causing losses to investors and increasing the risk of default on the Group's exposure to these sectors.

Whilst the US Federal Reserve increased its policy interest rates in December 2015 and December 2016, the US Federal Reserve's policy stance and the future trajectory of policy rates remain uncertain. It remains unclear whether other major central banks, including the Bank of England, will begin to raise their policy interest rates in the near term. Given the current disinflationary global environment and uncertain outlook for emerging market growth, it is possible that policy interest rate increases may not occur and some central banks, such as the European Central Bank

(the “ECB”) and Bank of England, may seek to lower policy interest rates further.

Although uncertainty remains about the timing of any increases by central banks, it is possible that any increase in interest rates may lead to increasing levels of defaults by the Group’s customers. Monetary policy has been highly accommodative in recent years, further supported by the Bank of England and HM Treasury “Funding for Lending” scheme, the “Help to Buy” scheme (which closed at the end of 2016), the “Term Funding Scheme” and the purchase of corporate bonds in the UK, which have helped to support demand at a time of very pronounced fiscal tightening and balance sheet repair. Such a long period of stimulus has increased uncertainty over the impact of its reduction, including the possibility of a withdrawal of such programmes which could lead to generally weaker than expected growth, or even contracting gross domestic product (GDP), reduced business and consumer confidence, higher levels of unemployment or underemployment, adverse changes to levels of inflation and falling property prices in the markets in which the Group operates, and consequently to an increase in delinquency rates and default rates among its customers. Similar risks result from the exceptionally low level of inflation in developed economies, which in Europe particularly could deteriorate into sustained deflation if policy measures prove ineffective. Reduced monetary stimulus and the actions and commercial soundness of other financial institutions have the potential to impact market liquidity. The adverse impact on the credit quality of the Group’s customers and counterparties, coupled with a decline in collateral values, could lead to a reduction in recoverability and value of the Group’s assets and higher levels of impairment allowances, which could have an adverse effect on the Group’s operations, financial condition or prospects.

## RISK FACTORS

Accommodative credit conditions in some areas of the world since the global financial crisis have led to a further build-up of debt, with private sector corporate debt in emerging markets growing particularly quickly. Emerging market currency depreciation and rising US interest rates may result in increasing difficulties in servicing this increased debt, especially debt that is denominated in US dollars, possibly leading to debt defaults, which may negatively affect economic growth in emerging markets or globally.

**The Group's businesses are inherently subject to the risk of market fluctuations, which could have a material adverse effect on the results of operations, financial condition or prospects of the Group.**

The Group's businesses are inherently subject to risks in financial markets and in the wider economy, including changes in, and increased volatility of, interest rates, inflation rates, credit spreads, foreign exchange rates, commodity, equity, bond and property prices and the risk that its customers act in a manner which is inconsistent with the Group's business, pricing and hedging assumptions. Movements in these markets will continue to have a significant impact on the Group in a number of key areas.

For example, adverse market movements have had and would have an adverse effect, which could be material, upon the financial condition of the defined benefit pension schemes of the Group. The schemes' main exposures are to real rate risk and credit spread risk. These risks arise from two main sources: the "AA" corporate bond liability discount rate and asset holdings.

Banking and trading activities that are undertaken by the Group are also subject to market movements, including interest rate risk, foreign exchange risk, inflation risk and credit spread risk. For example, changes in interest rate levels, interbank margins over official rates, yield curves and spreads affect the interest rate margin realised between lending and borrowing costs. The potential for future volatility and margin changes remains. Competitive pressures on fixed rates or product terms in existing loans and deposits may restrict the Group in its ability to change interest rates applying to customers in response to changes in official and wholesale market rates. The Group will continue to face interest rate margin compression in the prolonged low (or negative) interest rate environment and the yield on its structural hedge will reduce as reinvestment is undertaken at lower rates.

The insurance business of the Group is exposed indirectly to equity and credit markets through the value of future management charges on policyholder funds. Credit spread risk within insurance primarily arises from bonds and loans used to back annuities. The performance of the investment markets will thus have a direct impact upon the profit from investment contracts and on the insurance value in force (VIF) and the Group's operating results, financial condition or prospects.

Changes in foreign exchange rates, including with respect to the US dollar and the Euro, affect the Group's financial position and/or forecasted earnings. Foreign exchange risk is actively managed by the Group within a low risk

appetite, minimising the Group's exposure to exchange rate fluctuations.

**Market conditions have resulted, and are expected to result in the future, in material changes to the estimated fair values of financial assets of the Group. Negative fair value adjustments have had, and may continue to have in the future, an adverse effect on the Group's results of operations, financial condition or prospects.**

The Group has exposures to securities, derivatives and other investments, including asset-backed securities, structured investments and private equity investments that are recorded by the Group at fair value. These have been and may be subject to further negative fair value adjustments, particularly in view of the volatile global markets and challenging economic environment. Although credit value adjustments, debit value adjustments and funding value adjustments are actively managed within the Group, in stressed market conditions adverse movements in these could result in a material charge to the Group's profit and loss account.

In volatile markets, hedging and other risk management strategies (including collateralisation and the purchase of credit default swaps) may not be as effective as they are in normal market conditions, due in part to the decreasing credit quality of hedge counterparties, and general illiquidity in the markets within which transactions are executed. Asset valuations in future periods, reflecting prevailing market conditions, may result in further negative changes in the fair values of the Group's financial assets and these may also translate into increased impairment charges.

In circumstances where fair values are determined using financial valuation models, the Group's valuation methodologies may require it to make assumptions, judgements and estimates in order to establish fair value. These valuation models are complex and the assumptions used are difficult to make and are inherently uncertain. This is particularly relevant in light of uncertainty as to the strength of the global economic recovery and continuing downside risks and may be amplified during periods of market volatility and illiquidity. Any consequential impairments, write-downs or adjustments could have a material adverse effect on the Group's operating results, capital ratios, financial condition or prospects.

The value ultimately realised by the Group for its securities and other investments may be lower than their current fair value. Any of these factors could require the Group to record further negative fair value adjustments, which may have a material adverse effect on its operating results, financial condition or prospects. Material losses from the fair value of financial assets will also have an adverse impact on the Group's capital ratios.

**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.**

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, new entrants to the market (including a number of new retail banks as well as non-traditional financial services providers), consumer demand, technological changes such as the growth of digital banking, and the impact of regulatory actions and other factors. The Group's financial performance and its ability to maintain existing or capture additional market share



depends significantly upon the competitive environment and management's response thereto.

Notwithstanding this increase in competition described above, intervention by the UK Government competition authorities and/or European regulatory bodies and/or governments of other countries in which the Group operates, including in response to any perceived lack of competition within these markets by such regulatory authorities, may significantly impact the competitive position of the Group relative to its international competitors, which may be subject to different forms of government intervention, thus potentially putting the Group at a competitive disadvantage.

207

## RISK FACTORS

The Competition and Markets Authority (the “CMA”) launched a full market investigation into competition in the SME banking and personal current account (PCA) markets in November 2014 and published its final report on 9 August 2016. The key final remedies include: the introduction of “Open Banking”, the publication of service quality information and customer information prompts. Recommendations were also made regarding improvements to current account switching, monthly maximum charges for PCA overdraft users, overdraft notifications and additional measures to assist small business in comparing the different products available. Recent political debate on the reform of the UK banking markets, other current or potential competition reviews, the payment systems regulator and the FCA statutory objective to promote competition, along with concurrent competition powers, may lead to proposals or initiatives to reduce regulators’ competition concerns, and for greater UK Government and regulatory scrutiny in the future that may impact the Group further. Additionally, the Group may be affected by changes in regulatory oversight following the pension review recommended by the Department for Work and Pensions. For more information on the Group’s regulatory environment, see “—Regulation—Other Bodies Impacting the Regulatory Regime”.

The internet and mobile technologies are changing customer behaviour and the competitive environment. There has been a steep rise in customer use of mobile banking over the last four years. The Group faces competition from established providers of financial services as well as from banking business developed by non-financial companies, including technology companies with strong brand recognition.

As a result of any restructuring or evolution in the market, there may emerge one or more new viable competitors in the UK banking market or a material strengthening of one or more of the Group’s existing competitors in that market. Any of these factors or a combination thereof could result in a significant reduction in the profit of the Group.

## OPERATIONAL RISKS

### **The Group could fail to attract or retain senior management or other key employees.**

The Group’s success depends on its ability to attract, retain and develop high calibre talent. The Group’s achievement of this aim may be impacted by the introduction of the SMCR, which came into force on 7 March 2016. The SMCR includes a criminal offence of reckless misconduct, a statutory “duty of responsibility” to take reasonable steps to prevent regulatory breaches occurring or continuing in the area of the firm for which they have responsibility and increasing use of senior management attestations. In addition, the proposed limits on variable pay and “clawback” requirements which were introduced pursuant to CRD IV in the UK may put the Group at a competitive disadvantage compared to companies who are not subject to such restrictions. In addition, macro-economic conditions and negative media attention on the financial services industry may adversely impact employee retention, colleague sentiment and engagement.

In addition, the uncertainty resulting from the UK's exit from the EU, following the referendum decision, on foreign nationals' long-term residency permissions in the UK may make it challenging for the Group to retain and recruit adequate staff.

Failure to attract and retain senior management and key employees could have a material adverse effect on the Group's results of operations, financial condition or prospects.

**Operational risks such as weaknesses or failures in the Group's processes, systems and security and risks due to reliance on third party services and products could materially adversely affect the Group's operations, results of operations, financial condition or prospects, and could result in the reputational damage of the Group.**

Operational risks, through inadequate or failed processes, systems (including financial reporting and risk monitoring processes) or security, or from people-related or external events, including the risk of fraud and other criminal acts carried out against the Group, are present in the Group's businesses. The Group's businesses are dependent on processing and reporting accurately and efficiently a high volume of complex transactions across numerous and diverse products and services, in different currencies and subject to a number of different legal and regulatory regimes. Any weakness or errors in these processes, systems or security could have an adverse effect on the Group's results, reporting of such results, and on the ability to deliver appropriate customer outcomes during the affected period which may lead to an increase in complaints and damage to the reputation of the Group.

Specifically, failure to develop, deliver or maintain effective IT solutions in line with the Group's operating environment could have a material adverse impact on customer service and business operations. Any prolonged loss of service availability could damage the Group's ability to service its customers, could result in compensation costs and could cause long-term damage to the Group's business and brand. Furthermore, failure to protect the Group's operations from increasingly sophisticated cyber-attacks could result in the loss and/or corruption of customer data or other sensitive information. The resilience of the Group's IT infrastructure is of paramount importance to the Group; accordingly, significant investment has been, and will continue to be, made in IT infrastructure and supporting capabilities to ensure its resilience and subsequently the delivery of services to customers. The Group continues to invest in IT and information security control environments, including activity on user access management and records management to address evolving threats. The Group maintains contingency plans for a range of Group specific and industry wide IT and breach of security scenarios.

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. 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. Although the Group devotes significant resources to maintain and regularly update the processes and systems that are designed to protect the security of the Group's systems, software, networks and other technology assets, there is no assurance that all of the Group's security measures will provide absolute security. Any damage to the Group's reputation (including to customer confidence) arising from actual or perceived inadequacies, weaknesses or failures in Group systems, processes or security could have a material adverse

effect on the Group's results of operations, financial condition or prospects.

Third parties upon which the Group relies for important products and services could also be sources of operational risk, specifically with regard to security breaches affecting such parties. Many of the operational risks described above also apply when the Group relies on outside suppliers or vendors to provide key components of its business infrastructure. The Group may be required to take steps to protect the integrity of its operational systems, thereby increasing its operational costs. Additionally, any problems caused by these third parties, including as a result of their not providing the Group their services for any reason, their performing their services poorly, or employee misconduct, could adversely affect the Group's ability to deliver products and services to customers and otherwise to conduct business. Replacing these third party vendors could also entail significant delays and expense.

208

## RISK FACTORS

Notwithstanding anything in this risk factor, this risk factor should not be taken as implying that either the Company or any relevant company within the Group will be unable to comply with its obligations as a company with securities admitted to the Official List or as a supervised firm regulated by the FCA and/or the PRA.

### **The Group's business is subject to risks related to cybercrime.**

The Group relies on the effectiveness of its Group Information and Cyber Security Policies and associated procedures, infrastructure and capabilities to protect the confidentiality and integrity of information held on its IT infrastructure and the infrastructure of third parties on whom the Group relies. The Group also takes protective measures against attacks designed to impact the availability of critical business processes to its customers. Despite preventative measures, the Group's IT infrastructure, and that of third parties on whom the Group relies, may be vulnerable to cyber-attacks, sabotage, unauthorised access, computer viruses, worms or other malicious code, and other events that have a security impact. Such an event may impact the confidentiality or integrity of the Group's or its clients', employees' or counterparties' information or the availability of services to customers. As a result, the Group could experience material financial loss, loss of competitive position, regulatory actions, breach of client contracts, reputational harm or legal liability, which, in turn, could cause a decline in the Group's earnings. The Group may be required to spend additional resources to modify its protective measures or to investigate and remediate vulnerabilities or other exposures, and it may be subject to litigation and financial losses that are either not insured against fully or not fully covered through any insurance that it maintains. Any failure in the Group's cyber security policies, procedures or capabilities, or cyber-related crime, could lead to the Group suffering reputational damage, a loss of clients and could have a material adverse effect on the Group's results of operations, financial condition or prospects. The Group is committed to continued participation in industry-wide activity relating to cyber risk. This includes working with relevant regulatory and government departments to evaluate the approach the Group is taking to mitigate this risk.

### **Terrorist acts, other acts of war, geopolitical events, pandemics or other such events could have a material adverse effect on the Group's results of operations, financial condition or prospects.**

Terrorist acts, other acts of war or hostility, geopolitical events, pandemics or other such events and responses to those acts/events may create economic and political uncertainties, which could have a material adverse effect on UK and international macro-economic conditions generally, and more specifically on the Group's results of operations, financial condition or prospects in ways that cannot necessarily be predicted.

### **TSB servicing requirements may adversely impact the Group.**

As part of the divestment of TSB, the Group provides certain services to TSB which may result in reputational and financial exposure for the Group. For example, TSB relies on the Group for the provision of its IT systems and supporting infrastructure. The risks associated with provision of services to TSB include managing conflict of interests, the confidentiality of data, and competition risks as a part of providing services to a competitor bank. The Group's service provision obligations, and the associated risks, are expected to cease as TSB transitions services to Banco de Sabadell, S.A.

**The Group must comply with anti-money laundering, counter terrorist financing, anti-bribery and sanctions regulations, and a failure to prevent or detect any illegal or improper activities fully or on a timely basis could negatively impact customers and expose the Group to liability.**

The Group is required to comply with applicable anti-money laundering, anti-terrorism, sanctions, anti-bribery and other laws and regulations in the jurisdictions in which it operates. These laws and regulations require the Group, amongst other things, to adopt and enforce “know-your-customer” policies and procedures and to report suspicions of money laundering and terrorist financing, and in some countries specific transactions to the applicable regulatory authorities. These laws and regulations have become increasingly complex and detailed, require improved systems and sophisticated monitoring and compliance personnel, and have become the subject of enhanced government and regulatory supervision.

The Group has adopted policies and enhanced its procedures aimed at detecting and preventing the use of its banking network and services for money laundering, financing terrorism, and related activities, applying systems and controls on a risk-based approach throughout its businesses and operations. These controls, however, may not completely eliminate instances where third parties seek to use the Group’s products and services to engage in illegal or improper activities. In addition, while the Group reviews its relevant counterparties’ internal policies and procedures with respect to such matters, the Group, to a large degree, relies upon its relevant counterparties to maintain and properly apply their own appropriate anti-money laundering procedures. Such measures, procedures and compliance may not be completely effective in preventing third parties from using the Group (and its relevant counterparties) as a conduit for money laundering and terrorist financing (including illegal cash operations) without the Group’s (and its relevant counterparties’) knowledge. If the Group is associated with, or even accused of being associated with, or becomes a party to, money laundering or terrorist financing, the Group’s reputation could suffer and/or it could become subject to fines, sanctions and/or legal enforcement (including being added to any “black lists” that would prohibit certain parties from engaging in transactions with the Group), any one of which could have a material adverse effect on the Group’s operating results, financial condition and prospects.

To the extent that the Group fails to comply fully with applicable laws and regulations, the relevant government and regulatory agencies to which it reports have the power and authority to impose fines and other penalties on the Group, including the revocation of licences. In addition, the Group’s business and reputation could suffer if customers use its banking network for money laundering, financing terrorism, or other illegal or improper purposes.

**The Group may fail to execute its ongoing strategic change initiatives, and the expected benefits of such initiatives may not be achieved at the time or to the extent expected, or at all.**

The Group has a number of strategic initiatives which it pursues on an ongoing basis. For example, the Group has programmes for reducing costs, improving efficiency and financial performance, and enhancing the overall customer experience by simplifying and reshaping the Group’s businesses. As the Group continues to deliver this strategy there is considerable focus on digitisation and ensuring the Group meets customer demands through digital and mobile platforms. This approach will support the Group in achieving its cost targets.

The successful completion of these programmes and the Group's other strategic initiatives requires ongoing subjective and complex judgements, including forecasts of economic conditions in various parts of the world, and can be subject to significant execution risks. For example, the Group's ability to execute its strategic initiatives successfully may be adversely impacted by a significant global macroeconomic downturn, legacy issues, limitations in the Group's management or operational capacity or significant and unexpected regulatory change in countries in which the Group operates.

Failure to execute the Group's strategic initiatives successfully could have an adverse effect on the Group's ability to achieve the stated targets and other expected benefits of these initiatives, and there is also a risk that the costs associated with implementing such initiatives may be higher than the financial benefits expected to be achieved, which could materially adversely impact the Group's results of operations, financial condition or prospects.

## RISK FACTORS

**The Group may be unable to fully capture the expected value from acquisitions, which could materially and adversely affect the Group's results of operations, financial conditions or prospects.**

The Group may from time to time undertake acquisitions as part of its growth strategy, which could subject the Group to a number of risks, such as: (i) the rationale and assumptions underlying the business plans supporting the valuation of a target business may prove inaccurate, in particular with respect to synergies and expected commercial demand, (ii) the Group may fail to successfully integrate any acquired business, including its technologies, products and personnel, (iii) the Group may fail to retain key employees, customers and suppliers of any acquired business, (iv) the Group may be required or wish to terminate pre-existing contractual relationships, which could prove costly and/or be executed at unfavourable terms and conditions, (v) the Group may fail to discover certain contingent or undisclosed liabilities in businesses that it acquires, or its due diligence to discover any such liabilities may be inadequate and (vi) it may be necessary to obtain regulatory and other approvals in connection with certain acquisitions and there can be no assurance that such approvals will be obtained and even if granted, that there will be no burdensome conditions attached to such approvals, all of which could materially and adversely affect the Group's results of operations, financial conditions or prospects.

**The Group could be exposed to industrial action and increased labour costs resulting from a lack of agreement with trade unions.**

Within the Group, there are currently two recognised unions for the purposes of collective bargaining. Combined, these collective bargaining arrangements apply to around 95 per cent. of the Group's total workforce.

Where the Group or its employees or their unions seek to change any of their contractual terms, a consultation and negotiation process is undertaken. Such a process could potentially lead to increased labour costs or, in the event that any such negotiations were to be unsuccessful and result in formal industrial action, the Group could experience a work stoppage that could materially adversely impact its business, financial condition and results of operations.

## FINANCIAL SOUNDNESS RELATED RISKS

**The Group's businesses are subject to inherent risks concerning liquidity and funding, particularly if the availability of traditional sources of funding such as retail deposits or the access to wholesale funding markets becomes more limited.**

Liquidity and funding continues to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and long-term wholesale funding markets. Should the Group be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted.



The Group's profitability or solvency could be adversely affected if access to liquidity and funding is constrained or made more expensive for a prolonged period of time. Under extreme and unforeseen circumstances, such as the closure of financial markets and uncertainty as to the ability of a significant number of firms to ensure they can meet their liabilities as they fall due, the Group's ability to meet its financial obligations as they fall due or to fulfil its commitments to lend could be impacted through limited access to liquidity (including government and central bank facilities). In such extreme circumstances, the Group may not be in a position to continue to operate without additional funding support, which it may be unable to access. These factors may have a material adverse effect on the Group's solvency, including its ability to meet its regulatory minimum liquidity requirements. These risks can be exacerbated by operational factors such as an over-reliance on a particular source of funding or changes in credit ratings, as well as market-wide phenomena such as market dislocation, regulatory change or major disasters.

In addition, corporate and institutional counterparties may seek to reduce aggregate credit exposures to the Group (or to all banks) which could increase the Group's cost of funding and limit its access to liquidity. The funding structure employed by the Group may also prove to be inefficient, thus giving rise to a level of funding cost where the cumulative costs are not sustainable over the longer term. The funding needs of the Group may increase and such increases may be material to the Group's operating results, financial condition or prospects. The Group relies on customer savings and transmission balances, as well as ongoing access to the global wholesale funding markets to meet its funding needs. The ability of the Group to gain access to wholesale and retail funding sources on satisfactory economic terms is subject to a number of factors outside its control, such as liquidity constraints, general market conditions, regulatory requirements, the encouraged or mandated repatriation of deposits by foreign wholesale or central bank depositors and the level of confidence in the UK banking system, any of which could have a material adverse effect on the Group's profitability or, in the longer term and under extreme circumstances, its ability to meet its financial obligations as they fall due.

Medium-term growth in the Group's lending activities will rely, in part, on the availability of retail deposit funding on appropriate terms, for which there is increasing competition. For more information, see "*—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*" above. The ongoing availability of retail deposit funding on appropriate terms is dependent on a variety of factors outside the Group's control, such as general macro-economic conditions and market volatility, the confidence of retail depositors in the economy, the financial services industry and the Group, as well as the availability and extent of deposit guarantees. Increases in the cost of retail deposit funding will impact on the Group's margins and affect profit, and a lack of availability of retail deposit funding could have a material adverse effect on the Group's future growth.

Any loss in consumer confidence in the Group could significantly increase the amount of retail deposit withdrawals in a short period of time. Should the Group experience an unusually high and unforeseen level of withdrawals, in such extreme circumstances the Group may not be in a position to continue to operate without additional funding support, which it may be unable to access, which could have a material adverse effect on the Group's solvency.

If the wholesale funding markets were to suffer stress or central bank provision of liquidity to the financial markets is abruptly curtailed, or the Group's credit ratings are downgraded, it is likely that wholesale funding will prove more difficult to obtain. Such increased refinancing risk, in isolation or in concert with the related liquidity risks noted above, could have a material adverse effect on the Group's profitability and, in the longer term under extreme and

unforeseen circumstances, its ability to meet its financial obligations as they fall due.

210

## RISK FACTORS

**The Group's borrowing costs and access to the capital markets is dependent on a number of factors, including any reduction in the Group's longer-term credit rating, and increased costs or reduction in access could materially adversely affect the Group's results of operations, financial condition or prospects.**

A reduction in the credit rating of the Group or deterioration in the capital markets' perception of the Group's financial resilience could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. As an indicator, during 2016, the spread between an index of "A" rated long-term senior unsecured bank debt and an index of similar "BBB" rated bank debt, both of which are publicly available, has averaged 43 basis points. The applicability to and implications for the Group's funding cost would depend on the type of issuance and prevailing market conditions. The impact on the Group's funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

For the Company's and its subsidiaries' current ratings, see the section titled "*Operating and Financial Review—Funding and Liquidity Risk—Funding and Liquidity Management in 2016*".

Rating agencies regularly evaluate the Group and the Company, and their ratings of longer-term debt are based on a number of factors, including the Group's financial strength as well as factors not entirely within the Group's control, including conditions affecting the financial services industry generally. In light of the difficulties in the financial services industry and the financial markets, there can be no assurance that the Group or the Company will maintain their current ratings. Downgrades of the Group's longer-term credit rating could lead to additional collateral posting and cash outflow. The effects of a potential downgrade from all three rating agencies are included in the Group liquidity stress testing. As at 31 December 2016, a hypothetical instantaneous two notch downgrade of the Group's current long-term credit rating and accompanying short-term downgrade implemented simultaneously by all major rating agencies could result in a contractual outflow of £3.1 billion of cash over a period of up to one year, £1.8 billion of collateral posting related to customer financial contracts and £9.0 billion of collateral posting associated with secured funding, calculated on an unaudited basis.

The regulatory environment in which the Group operates continues to change. Whilst uncertain at present, the Group's borrowing costs and access to capital markets could be affected by the outcome of certain regulatory developments. For further detail on the potential impact of these regulatory developments on the Group's business, see "*—Regulatory and legal risks — The Group faces risks associated with an uncertain and rapidly evolving international prudential legal and regulatory environment*".

**The Group is subject to the risk of having insufficient capital resources.**

If the Group has or is perceived to have a shortage of capital then it may be subject to regulatory interventions and sanctions and may suffer a loss of confidence in the market with the result that access to liquidity and funding may become constrained or more expensive. Depending on the extent of any actions to improve the capital position there could be a material adverse effect on the Group's business, including its operating results, financial condition and

prospects. This, in turn, may affect the Group's capacity to continue its business operations, pay future dividends and make other distributions or pursue acquisitions or other strategic opportunities, impacting future growth potential. If, in response to such shortage, the Group raises additional capital through the issuance of share capital or capital instruments, existing shareholders or holders of debt of a capital nature may experience a dilution of their holdings. If a capital or debt instrument is converted to share capital as a result of a trigger within the contractual terms of the instrument or through the exercise of statutory powers then, depending upon the terms of the conversion, existing shareholders may experience a dilution of their holdings. Separately, the Group may address a shortage of capital by taking action to reduce leverage and/or risk-weighted assets or by business disposals. Such actions may impact the underlying profitability of the Group.

A shortage of capital could arise from:

- a depletion of the Group's capital resources through increased costs or liabilities and reduced asset values which could arise as a result of the crystallisation of credit-related risks, regulatory and legal risks, business and economic risks, operational risks, financial soundness-related risks, government related risks and other risks described herein; and/or

- an increase in the amount of capital that is needed to be held. This might be driven by a change to the actual level of risk faced by the Group or to changes in the minimum levels required by legislation or by the regulatory authorities, or it may be driven by an increase to the Group's view of the management buffer it should hold taking account of, for example, the capital levels or capital targets of the Group's peer banks or through the changing views of rating agencies.

Risks associated with the regulatory framework are described below:

Within the prevailing UK regulatory capital framework, the Group is subject to extensive regulatory supervision in relation to the levels of capital in its business. New or revised minimum and buffer capital requirements (including systemic and/or countercyclical capital requirements) could be applied and/or the manner in which existing regulatory requirements are applied to the Group could be changed by the regulatory authorities. For example:

- Some of the Group's risk-weighted assets are calculated from the Group's approved models. These are subject to regular review on a rolling basis to ensure that they remain appropriate in prevailing economic and business conditions. In addition, ongoing consultations by the Basel Committee, the EBA and the PRA in relation to changes in how firms model probability of default and Loss Given Default within capital models, including the introduction of parameter floors, may result in changes to the Group's approved models. These reviews and model implementation may lead to increased levels of risk-weighted assets and/or expected loss, and so to lower reported capital ratios.

- The minimum capital requirements derived from risk-weighted assets are supplemented by the PRA, under Pillar 2 of the regulatory capital framework, through bank specific additional minimum requirements (informed by the PRA's Internal Capital Adequacy Assessment Process (ICAAP) and set through the PRA's Individual Capital Guidance) and through buffer requirements (informed by the outcome of PRA stress testing and which may include an additional buffer to cover the risk posed by any weaknesses in risk management and governance). There is a risk that through these Pillar 2 processes the PRA may require the Group to hold more capital than is currently planned.

In addition, the regulatory framework continues to evolve, which may impact the Group's capital position, for further detail see "*—Regulatory and legal risks - The Group faces risks associated with an uncertain and rapidly evolving international prudential legal and regulatory environment*" above.

211

## RISK FACTORS

**The Group has been and could continue to be negatively affected by the soundness and/or the perceived soundness of other financial institutions, which could result in significant systemic liquidity problems, losses or defaults by other financial institutions and counterparties, and which could materially adversely affect the Group's results of operations, financial condition or prospects.**

The Group is subject to the risk of deterioration of the commercial soundness and/or perceived soundness of other financial services institutions within and outside the UK. Financial services institutions that deal with each other are interrelated as a result of trading, investment, clearing, counterparty and other relationships. This presents systemic risk and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges with which the Group interacts on a daily basis, all of which could have a material adverse effect on the Group's ability to raise new funding.

The Group routinely executes a high volume of transactions with counterparties in the financial services industry, resulting in a significant credit concentration. A default by, or even concerns about the financial resilience of, one or more financial services institutions could lead to further significant systemic liquidity problems, or losses or defaults by other financial institutions, which could have a material adverse effect on the Group's results of operations, financial condition or prospects.

**The Group's insurance business and defined benefit pension schemes are subject to insurance risks which could adversely affect the Group's results of operations, financial condition or prospects.**

The insurance business of the Group is exposed to short-term and longer-term variability arising from uncertain longevity due to annuity portfolios. The Group's defined benefit pension schemes are also exposed to longevity risk. Increases in life expectancy (longevity) beyond current allowances will increase the cost of annuities and pension scheme benefits and may adversely affect the Group's financial condition and results of operations.

Customer behaviour in the insurance business may result in increased cancellations or ceasing of contributions at a rate in excess of business assumptions. Consequent reduction in policy persistency and fee income would have an adverse impact upon the profitability of the insurance business of the Group.

The insurance business of the Group is also exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims and higher levels of theft can increase claims on home insurance. These claims rates may differ from business assumptions and negative developments may adversely affect the Group's financial condition and results of operations.

To a lesser extent the insurance business is exposed to mortality, morbidity and expense risk. Adverse developments in any of these factors may adversely affect the Group's financial condition and results of operations.

UK banks can recognise an insurance asset in their balance sheets representing the VIF of the business in respect of long-term life assurance contracts, being insurance contracts and investment contracts with discretionary participation features. This asset represents the present value of future profits expected to arise from the portfolio of in-force life assurance contracts. Adoption of this accounting treatment results in the earlier recognition of profit on new business, but subsequently a lower contribution from existing business, when compared to the recognition of profits on investment contracts under IAS 39 (Financial Instruments: “Recognition and Measurement”). Differences between actual and expected experience may have a significant impact on the value of the VIF asset, as changes in experience can result in significant changes to modelled future cash flows. The VIF asset is calculated based on best-estimate assumptions made by management, including mortality experience and persistency. If these assumptions prove incorrect, the VIF asset could be materially reduced, which in turn could have a material adverse effect on the Group’s results of operations, financial condition or prospects.

## **GOVERNMENT RELATED RISKS**

### **Until it ceases to be a shareholder, the Solicitor for the Affairs of HM Treasury might seek to exert influence over the Group and its business through its shareholding in, and other relationships with, the Company.**

At Friday 24 February, HM Treasury held approximately 3.89 per cent. of the Company’s ordinary share capital. The relationship falls within the scope of the revised framework document between HM Treasury and UKFI published on 1 October 2010, which states that UKFI will manage the investments in the UK financial institutions in which HM Treasury holds an interest “on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (as defined therein) (including with respect to individual lending or remuneration decisions)”. The framework document also makes it clear that such UK financial institutions will continue to be separate economic units with independent powers of decision. Although HM Treasury’s shareholding level has decreased significantly over time and is expected to continue to decrease, the revised framework document remains in place and will continue to do so until HM Treasury ceases to be a shareholder of the Company. Until such time, there is a risk that, through its relationship with, and shareholding in, the Company, HM Treasury and the UK Government may attempt to influence the Group in ways that could affect the Group’s business.

HM Treasury also has interests in other UK financial institutions, as well as an interest in the general health of the UK banking industry and the wider UK economy. The pursuit of those interests may not always be aligned with the commercial interests of the Group.

For more information, see “—Regulatory and legal risks — The Group and its businesses are subject to substantial regulation and oversight. Adverse legal or regulatory developments could have a significant material adverse effect on the Group’s results, operations, financial condition or prospects.” above.

## RISK FACTORS

### OTHER RISKS

#### **The Group's financial statements are based, in part, on assumptions and estimates.**

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to the Group's results and financial position, based upon materiality and significant judgements and estimates, which include impairment losses on loans and receivables, valuation of financial instruments, pensions, insurance and taxation as set out in the Company's Annual Report 2016 filed with the SEC on Form 20-F in "*Note 3 to the consolidated financial statements—Critical accounting estimates and judgements*".

The consolidated financial statements are prepared using judgements, estimates and assumptions based on information available at the reporting date. If one or more of these judgements, estimates and assumptions is subsequently revised as a result of new factors or circumstances emerging, there could be a material adverse effect on the Group's results of operations, financial condition or prospects and a corresponding impact on its funding requirements and capital ratios.

In July 2014, the International Accounting Standards Board (the "IASB") published a new accounting standard for financial instruments (IFRS 9) that will introduce a new model for recognising and measuring impairment based on expected credit losses, rather than an incurred loss model currently applied under IAS 39 (Financial Instruments: "Recognition and Measurement"), resulting in earlier recognition of credit losses. The changes are likely to result in an increase in the Group's balance sheet provisions for credit losses and may therefore negatively impact the Group's regulatory capital position. The extent of any increase in provisions will depend on, among other things, the composition of the Group's lending portfolios and forecast economic conditions at the date of implementation. The new standard will be effective for annual periods beginning on or after 1 January 2018. The Basel Committee is consulting on arrangements to transition in the impact of IFRS 9 from a regulatory capital basis under the CRD V proposals, however, these are not expected to come into force until 2019 at the earliest (see "*—Regulatory and legal risks—The Group faces risks associated with an uncertain and rapidly evolving international prudential, legal and regulatory environment – Evolving European and Global Prudential and Regulatory Changes*").

The IASB has issued IFRS 16 to replace IAS 17 (Leases) which is effective for annual periods beginning on or after 1 January 2019. IFRS 16 requires lessees to recognise a right of use asset and a liability for future payments arising from a lease contract. This change will mainly impact the accounting for the properties that the Group currently accounts for as operating leases. Lessor accounting requirements remain aligned to the current approach under IAS 17. The capital treatment of the new assets and liabilities recognised under IFRS 16 is unclear.



In addition, an amendment to accounting standard IFRIC 14 (The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction) is expected to be issued in 2017. This could add an additional minimum liability to the Group's financial statements in respect of one of the Group's defined benefit pension schemes.

**The Company is dependent on the receipt of dividends from its subsidiaries to meet its obligations, including its payment obligations with respect to its debt securities.**

The Company is a non-operating holding company. The principal sources of the Company's income are, and are expected to continue to be, distributions from operating subsidiaries which also hold the principal assets of the Group. As a separate legal entity, the Company relies on such distributions in order to be able to meet its obligations (including its payment obligations with respect to its debt securities), and to create distributable reserves for payment of dividends to ordinary shareholders.

The ability of the Company's subsidiaries (including subsidiaries incorporated outside the UK) to pay dividends and the Company's ability to receive distributions from its investments in other entities will also be subject not only to their financial performance but also to applicable local laws and other restrictions. These restrictions could include, among others, any regulatory requirements, leverage requirements, any statutory reserve requirements and any applicable tax laws. There may also be restrictions as a result of current or forthcoming local ring-fencing requirements, including those relating to the payment of dividends and the maintenance of sufficient regulatory capital on a sub-consolidated basis at the level of the RFB. These laws and restrictions could limit the payment of dividends and distributions to the Company by its subsidiaries and any other entities in which it holds an investment from time to time, which could restrict the Company's ability to meet its obligations and/or to pay dividends.

**The Company may not pay a dividend on its ordinary shares in any given financial/calendar year.**

The determination of the Board of Directors of the Company (the "Board") in any given year of whether the Company can or should pay a dividend on its ordinary shares, or the amount of such dividend, is subject to a number of factors. These include, among other things, the amount of capital the Group has generated over the year, the amount of regulatory capital it is required to retain by the PRA and other regulatory authorities, and the level of investment the Board determines is in the best interests of the Group to responsibly foster the growth of the business.

The Company's ability to pay dividends may be adversely affected by the performance of the Group's business in general, factors affecting its financial position (including capital, funding, liquidity and leverage), the economic environment in which the Group operates, the contractual terms of certain of the Group's regulatory capital securities and other factors outside of the Group's control, which could arise as a result of the crystallisation of credit-related risks, regulatory and legal risks, business and economic risks, operational risks, financial soundness-related risks, government related risks and other risks described herein, many of which may impact the amount of capital that is generated over the course of the year.

## RISK FACTORS

As the parent company of a banking group, the Company's ability to pay dividends in the future is also dependent on the maintenance of an adequate level of regulatory capital. The Company's ability to pay dividends may be affected by minimum regulatory requirements imposed by the PRA under the CRD IV requirements as implemented in the UK. The Company is also required by the PRA to maintain a number of regulatory capital buffers which may adversely impact the Company's ability to distribute its reserves. The level at which these buffers may be set is determined by the CRD IV rules and the requirements of the PRA buffer. Often, the PRA notifies the Company of minimum regulatory capital requirements applicable to the Group for the coming year only a short time ahead of the Company's dividend declaration for the prior year. This means that neither the Board nor the Company's investors may be able to accurately predict the Company's ability to pay dividends. For further detail on the potential impact of these requirements on the Company's ability to pay dividends on its ordinary shares, see "*—Regulatory and Legal Risks—The Group faces risks associated with an uncertain and rapidly evolving international prudential, legal and regulatory environment*" and "*—Financial soundness-related Risks—The Group is subject to the risk of having insufficient capital resources*".

In addition, the Board must determine in any given year the optimum level of investment to responsibly foster growth and to fund investment initiatives in the business, including organic growth or growth through acquisitions as part of its growth strategy, as well as the appropriate level of retained earnings for the Company as a prudential matter to meet evolving regulatory requirements and to cover uncertainties. These determinations will change year on year based on factors such as the economic cycle and macro-economic outlook, uncertainty in the regulatory and prudential environment, and relevant opportunities available to the Group at any given point in time. The Board's decisions in relation to these matters will have an impact on the ability of the Company to pay a dividend on its ordinary shares in any given year.

**Volatility in the price of the Company's ordinary shares may affect the value of any investment in the Company.**

The market price of the Company's ordinary shares could be volatile and subject to significant fluctuations due to various factors, some of which may be unrelated to the Group's operating performance or prospects. These include economic or political disruption in the main jurisdictions in which the Group operates, any regulatory changes affecting the Group's operations, developments in the industry or its competitors, the operating and share price performance of other companies in the industries and markets in which the Group operates, the potential placing of large volumes of the Company's ordinary shares in the market, or speculation about the Group's business in the press, media or investment communities. Furthermore, the Group's operating results and prospects from time to time may vary from the expectations of rating agencies, market analysts or investors. Any of these events could result in volatility in the market prices of the Company's ordinary shares. In general, prospective investors should be aware that the value of an investment in the Company's ordinary shares may go down as well as up.

**Failure to manage the risks associated with changes in taxation rates or applicable tax laws, or misinterpretation of such tax laws, could materially adversely affect the Group's results of operations, financial condition or prospects.**

Tax risk is the risk associated with changes in taxation rates, applicable tax laws, misinterpretation of such tax laws, disputes with relevant tax authorities in relation to historic transactions or conducting a challenge to a relevant tax

authority. Failure to manage this risk adequately could cause the Group to suffer losses due to additional tax charges and other financial costs including penalties. Such failure could lead to adverse publicity, reputational damage and potentially costs materially exceeding current provisions, in each case to an extent which could have an adverse effect on the Group's results of operations, financial condition or prospects.

## FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements within the meaning of Section 21E of the US Securities Exchange Act of 1934, as amended, and section 27A of the US Securities Act of 1933, as amended, with respect to the business, strategy and plans of Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Lloyds Banking Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'like', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of Lloyds Banking Group or its management including in respect of statements about the future business and economic environments in the UK and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates (including low or negative rates), exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Group's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, the exit by the UK from the European Union (EU) and the potential for one or more other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to cyber security; natural, pandemic and other disasters, adverse weather and similar contingencies outside the Group's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the Group's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the United States or elsewhere including the implementation and interpretation of key legislation and regulation; the ability to attract and retain senior management and other employees; requirements or limitations on the Group as a result of HM Treasury's investment in the Group; actions or omissions by the Group's directors, management or employees including industrial action; changes to the Group's post-retirement defined

benefit scheme obligations; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this document are made as of the date hereof, and Lloyds Banking Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this document to reflect any change in Lloyds Banking Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

The information, statements and opinions contained in this document do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

## LLOYDS BANKING GROUP STRUCTURE

The following is a list of the significant subsidiaries of Lloyds Banking Group plc at 31 December 2016.

Name of subsidiary undertaking	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business	Registered office
Lloyds Bank plc	England	100%	Banking and financial services	25 Gresham Street London EC2V 7HN
Scottish Widows Limited	Scotland	100%*	Life assurance	25 Gresham Street London EC2V 7HN
HBOS plc	Scotland	100%*	Holding company	The Mound Edinburgh EH1 1YZ
Bank of Scotland plc	Scotland	100%*	Banking and financial services	The Mound Edinburgh EH1 1YZ

\*Indirect interest  
216

INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

<u>Report of the Independent Registered Public Accounting Firm</u>	F-2
<u>Consolidated income statement for the three years ended 31 December 2016, 31 December 2015 and 31 December 2014</u>	F-3
<u>Consolidated statement of comprehensive income for the three years ended 31 December 2016, 31 December 2015 and 31 December 2014</u>	F-4
<u>Consolidated balance sheet at 31 December 2016 and 31 December 2015</u>	F-5
<u>Consolidated statement of changes in equity for the three years ended 31 December 2016, 31 December 2015 and 31 December 2014</u>	F-7
<u>Consolidated cash flow statement for the three years ended 31 December 2016, 31 December 2015 and 31 December 2014</u>	F-9
<u>Notes to the consolidated financial statements</u>	F-10
F-1	

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

**TO THE SHAREHOLDERS OF LLOYDS BANKING GROUP PLC**

In our opinion, the accompanying consolidated balance sheets and the related consolidated income statements, consolidated statements of comprehensive income, consolidated statements of changes in equity and consolidated cash flow statements present fairly, in all material respects, the financial position of Lloyds Banking Group plc and its subsidiaries (the Company) at 31 December 2016 and 31 December 2015 and the results of their operations and their cash flows for each of the three years in the period ended 31 December 2016, in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board. Also, in our opinion the Company maintained, in all material respects, effective internal control over financial reporting as of 31 December 2016, based on criteria established in Internal Control Integrated Framework (2013) issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the Management Report on Internal Control over Financial Reporting appearing on page 175 of the 2016 Annual Report on Form 20-F. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may



deteriorate.

/s/ PricewaterhouseCoopers LLP  
London, United Kingdom  
10 March 2017

F-2

## CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Note	2016 £ million	2015 £ million	2014 £ million
Interest and similar income		16,620	17,615	19,211
Interest and similar expense		(7,346 )	(6,297 )	(8,551 )
<b>Net interest income</b>	5	<b>9,274</b>	11,318	10,660
Fee and commission income		3,045	3,252	3,659
Fee and commission expense		(1,356 )	(1,442 )	(1,402 )
Net fee and commission income				