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

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

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

FORM 20-F

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

OR

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

OR

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

OR

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

Commission file number 001-15246

LLOYDS BANKING GROUP plc

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

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

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

Title of each class	**Name of each exchange on which registered**
Ordinary shares of nominal value 25 pence each, represented by American Depositary Shares.	The New York Stock Exchange.

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

None

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

None

The number of outstanding shares of each of Lloyds Banking Group plc s classes of capital or common stock as of 31 December 2008 was:

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

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

Yes x No o

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

Yes o No x

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

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

Yes x No o

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

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

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

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

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

Item 17 o Item 18 o

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

Yes o No x

TABLE OF CONTENTS

PRESENTATION OF INFORMATION

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds (pounds sterling , sterling or £), the lawful currency of the UK. In this annual report, references to pence and p are to one-hundredth of one pound sterling; references to US dollars , US$ or $ are to the lawful currency of the United States (the US); references to cent or c are to one-hundredth of one US dollar; references to euro or e are to the lawful currency of the member states of the European Union that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to euro cent are to one-hundredth of one euro; and references to Japanese yen Japanese ¥ or ¥ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2008, which was $1.4619 = £1.00. The Noon Buying Rate on 31 December 2008 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

BUSINESS OVERVIEW

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

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

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

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

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

* Volatility relates to Insurance and Investments.

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

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

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

Lloyds Banking Group plc (previously Lloyds TSB Group plc) was incorporated as a public limited company and registered in Scotland under the UK Companies Act 1985 on 21 October 1985 with the registered number 95000. Lloyds Banking Group plc s registered office is Henry Duncan House, 120 George Street, Edinburgh EH2 4LH, Scotland, and its principal executive offices in the UK are located at 25 Gresham Street, London, EC2V 7HN, United Kingdom, telephone number + 44 (0) 20 7626 1500.

SELECTED CONSOLIDATED FINANCIAL DATA

The financial information set out in the tables below has been derived from the annual reports and accounts of Lloyds Banking Group plc for each of the past four years adjusted for subsequent changes in accounting policy and presentation. These tables have been prepared in accordance with IFRS. The financial statements for each of the years 2004 to 2008 have been audited by PricewaterhouseCoopers LLP, independent accountants.

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

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

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

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

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

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

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

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

EXCHANGE RATES

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

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

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

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

On 17 April 2009, the latest practicable date, the US dollar Noon Buying Rate was $1.4778 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

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

STRATEGY OF LLOYDS BANKING GROUP

Since 2003 the Group strategy has focused on:

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

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

MARKETS

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

BUSINESS

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

STRATEGY

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

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

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

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

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

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

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

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

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

SUMMARY

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

BUSINESS

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

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

UK RETAIL BANKING

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

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

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

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

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

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

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

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

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

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

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

INSURANCE AND INVESTMENTS

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

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

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

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

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

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

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

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

BUSINESS

WHOLESALE AND INTERNATIONAL BANKING

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

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

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

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

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

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

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

LLOYDS BANKING GROUP SEGMENTS IN 2009

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

MATERIAL CONTRACTS

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

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

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

2009 PLACING AND OPEN OFFER AGREEMENT

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

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

BUSINESS

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

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

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

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

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

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

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

(iv) the obtaining of regulatory approvals; and

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

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

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

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

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

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

LENDING COMMITMENTS DEED

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

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

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

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

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

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

BUSINESS

PRE-ACCESSION DEED

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

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

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

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

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

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

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

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

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

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

PROPERTIES

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

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

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

LEGAL ACTIONS

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

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

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

COMPETITIVE ENVIRONMENT

Lloyds Banking Group is a diversified UK-based financial services group providing a wide range of banking and financial services, predominantly in the UK, to personal and corporate customers. Its main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision.

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

BUSINESS

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

RECENT DEVELOPMENTS

SHARE CAPITAL

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

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

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

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

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

ACQUISITION OF HBOS PLC

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

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

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

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

CAPITALISATION ISSUE

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

NAME CHANGE

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

UK GOVERNMENT ASSET PROTECTION SCHEME

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

SCHEME AMOUNT

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

BUSINESS

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

FIRST LOSS

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

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

FEE AND RELATED ISSUANCE OF CAPITAL

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

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

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

CAPITAL RESTRUCTURING REPLACEMENT OF EXISTING PREFERENCE SHARES

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

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

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

IMPACT OF PREFERENCE SHARE REPLACEMENT AND B SHARE CONVERSION

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

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

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

LENDING

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

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

TERM

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

ONGOING MANAGEMENT OF THE COVERED ASSETS

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

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

BUSINESS

CONDITIONS TO ACCESSION TO GAPS

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

BOARD CHANGE

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

INTERIM MANAGEMENT STATEMENT

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

KEY HIGHLIGHTS

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

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

Eric Daniels, Group Chief Executive, commented:

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

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

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

GOOD REVENUE GROWTH IN THE FIRST QUARTER OF 2009

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

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

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

STRONG GROUP COST PERFORMANCE

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

RISING IMPAIRMENT LEVELS

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

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

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

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

IMPROVING CAPITAL RATIOS AND STRONG LIQUIDITY AND FUNDING POSITION

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

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

INTENDED PARTICIPATION IN THE GOVERNMENT ASSET PROTECTION SCHEME

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The results discussed below are not necessarily indicative of Lloyds Banking Group s results in future periods. Unless expressly indicated, the results discussed in this section as well as the consolidated financial statements of Lloyds Banking Group included herein do not reflect the results of HBOS, which will be consolidated for the first time in 2009 and will therefore impact the comparability of 2009 and future periods with the results discussed below. The following information contains certain forward looking statements. For a discussion of certain cautionary statements relating to forward looking statements, see Forward looking statements .

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

TABLE OF CONTENTS

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OVERVIEW AND TREND INFORMATION

THE ECONOMY AND THE GROUP S MARKETS

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

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

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

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

THE ECONOMY IN 2008

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

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

UK GDP GROWTH

UK CONSUMER SPENDING GROWTH

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPACT ON THE GROUP S MARKETS

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

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

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

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

THE OUTLOOK

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

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

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

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

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

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

16

CRITICAL ACCOUNTING POLICIES

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

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

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group s IFRS reporting are discussed in note 51 to the consolidated financial statements.

RESULTS OF OPERATIONS 2008, 2007 AND 2006

SUMMARY

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED WITH 2007

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

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

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

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

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

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2007 COMPARED WITH 2006

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

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

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

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

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

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

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

2008 COMPARED TO 2007

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2007 COMPARED TO 2006

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

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

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

OTHER INCOME

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

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

21

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2008 COMPARED TO 2007

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

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

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

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

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

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

2007 COMPARED TO 2006

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

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

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

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

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

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

OPERATING EXPENSES

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

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

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

2008 COMPARED TO 2007

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

Staff costs were £27 million, or 1 per cent, higher at £2,931 million in 2008 compared to £2,904 million in 2007. Salaries were £56 million, or 3 per cent, higher at £2,183 million. There was a small increase in staff numbers which, together with the effect of the annual pay awards, more than offset staff reductions following the sale of businesses during 2007. National insurance costs were £9 million, or 5 per cent, higher at £176 million compared to £167 million in 2007. Pension costs were £3 million, or 1 per cent, lower at £235 million compared to £238 million in 2007; this small reduction arises because an £8 million increase in the cost of contributions to defined contribution pension schemes (which cover all eligible new employees) has been more than offset by an £11 million reduction in the charge in respect of defined benefit schemes (following further increases in asset values

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

and expected returns at the end of 2007). Other staff costs were £35 million, or 9 per cent, lower at £337 million compared to £372 million in 2007; a further increase in costs for agency staff (used to cover project work), has been more than offset by a decrease in redundancy costs as the level of particular restructuring initiatives seen in 2007 has not been repeated in 2008.

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

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

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

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

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

2007 COMPARED TO 2006

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

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

	2008 £m	2007 £m	2006 £m
UK Retail Banking	**1,472**	1,224	1,238
Insurance and Investments	**2**		
Wholesale and International Banking	**1,402**	497	313
Central group items			9
Total charge for impairment losses on loans and advances	**2,876**	1,721	1,560

	%	%	%
Charge for impairment losses on loans and advances			