Lloyds Banking Group plc
Form 20-F
February 25, 2019

As filed with the Securities and Exchange Commission on 25 February 2019

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 2018
OR

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

OR

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

Commission file number 001-15246

LLOYDS BANKING GROUP plc

(previously Lloyds TSB Group plc)

(Exact name of Registrant as Specified in Its Charter)

Scotland

(Jurisdiction of Incorporation or Organization)

25 Gresham Street

London EC2V 7HN

United Kingdom

(Address of Principal Executive Offices)

Malcolm Wood, Company Secretary

Tel +44 (0) 20 7356 1274, Fax +44 (0) 20 7356 1808

25 Gresham Street

London EC2V 7HN

United Kingdom

(Name, telephone, e-mail and/or facsimile number and address of Company contact person)

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

Title of each class	Name of each exchange on which registered
Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares	The New York Stock Exchange
$1,500,000,000 4.344% Subordinated Securities due in 2048	The New York Stock Exchange
$824,033,000 5.3% Subordinated Securities due 2045	The New York Stock Exchange
$1,750,000,000 3.574% Senior Notes due in 2028 (callable in 2027)	The New York Stock Exchange
$1,500,000,000 4.375% Senior Notes due 2028	The New York Stock Exchange
$1,250,000,000 4.55% Senior Notes due 2028	The New York Stock Exchange
$1,250,000,000 3.75% Senior Notes due 2027	The New York Stock Exchange
$1,500,000,000 4.65% Subordinated Securities due 2026	The New York Stock Exchange
$1,500,000,000 4.45% Senior Notes due 2025	The New York Stock Exchange
$1,327,685,000 4.582% Subordinated Securities due 2025	The New York Stock Exchange
$1,250,000,000 3.5% Senior Notes due 2025	The New York Stock Exchange
$1,000,000,000 4.5% Subordinated Securities due 2024	The New York Stock Exchange
$1,750,000,000 4.05% Senior Notes due 2023	The New York Stock Exchange
$2,250,000,000 2.907% Senior Notes due 2023 (callable in 2022)	The New York Stock Exchange
$1,500,000,000 3.0% Senior Notes due 2022	The New York Stock Exchange
$1,250,000,000 3.3% Senior Notes due 2021	The New York Stock Exchange
$1,000,000,000 Floating Rate Senior Notes due 2021	The New York Stock Exchange
$500,000,000 Floating Rate Senior Notes due 2021	The New York Stock Exchange
$1,000,000,000 3.1% Senior Notes due 2021	The New York Stock Exchange
$2,500,000,000 6.375% Senior Notes due 2021	The New York Stock Exchange
$1,000,000,000 2.7% Senior Notes due 2020	The New York Stock Exchange
$1,000,000,000 2.4% Senior Notes due 2020	The New York Stock Exchange
$1,000,000,000 2.35% Senior Notes due 2019	The New York Stock Exchange
$750,000,000 2.05% Senior Notes due 2019	The New York Stock Exchange
$450,000,000 Floating Rate Notes due 2019	The New York Stock Exchange

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

None

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

7.50% Fixed Rate Reset Additional Tier 1 Perpetual Subordinated Contingent Convertible Securities

The number of outstanding shares of each of Lloyds Banking Group plc's classes of capital or common stock as of 31 December 2018 was:

Ordinary shares, nominal value 10 pence each	71,163,592,264
Preference shares, nominal value 25 pence each	412,204,151
Preference shares, nominal value 25 cents each	809,160
Preference shares, nominal value 25 euro cents each	Nil

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

Yes x   No o

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

Yes o   No x

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

Yes x   No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x   No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or an emerging growth company.

See the definitions of "large accelerated filer," "accelerated filer," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x   Accelerated filer o   Non-Accelerated filer o   Emerging Growth Company o

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards† provided pursuant to Section 13(a) of the Exchange Act.

Yes o No o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements including in this filing:
U.S. GAAP o International Financial Reporting Standards as issued by the International Accounting Standards Board x Other o

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

Item 17 o Item 18 o

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

Yes o No x

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

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PRESENTATION OF INFORMATION

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds (‘pounds sterling’, ‘sterling’ or ‘£’), the lawful currency of the UK. In this annual report, references to ‘pence’ and ‘p’ are to one-hundredth of one pound sterling; references to ‘US dollars’, ‘US$’ or ‘$’ are to the lawful currency of the United States (the US); references to ‘cent’ or ‘c’ are to one-hundredth of one US dollar; references to ‘euro’ or ‘€’ are to the lawful currency of the member states of the European Union (EU) that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to ‘euro cent’ are to one-hundredth of one euro; and references to ‘Japanese yen’, ‘Japanese ¥’ or ‘¥’ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2018. The Noon Buying Rate on 31 December 2018 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.

The comparative information included in the consolidated financial statements presented in this Form 20-F differs from the comparative information provided in the Group’s UK results for the year ended 31 December 2018. As reported in the Company’s 2016 Form 20-F, an adjusting post balance sheet event that occurred between the signing of the Group’s 2016 UK Annual Report and Accounts and its 2016 Form 20-F resulted in the charge recognised in respect of PPI complaints in the Company’s 2016 Form 20-F being £350 million greater than that recorded in the Group’s 2016 UK Annual Report and Accounts. Consequently, the charge recognised by the Group in its UK basis results for 2017 was £350 million greater than on a US basis. The Group has reported the same net assets on a US basis and on a UK basis since 31 March 2017.

BUSINESS OVERVIEW

Lloyds Banking Group is a leading provider of financial services to individual and business customers in the UK. At 31 December 2018, total Lloyds Banking Group assets were £797,598 million and Lloyds Banking Group had 64,928 employees (on a full-time equivalent basis). Lloyds Banking Group plc’s market capitalisation at that date was £36,898 million. The Group reported a profit before tax for the 12 months to 31 December 2018 of £5,960 million, and its capital ratios at that date were 22.9 per cent for total capital, 18.2 per cent for tier 1 capital and 14.6 per cent for common equity tier 1 capital.

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

	2018 £m	2017 £m	2016 £m
Net interest income	13,396	10,912	9,274
Other income	8,695	23,325	30,337
Total income	22,091	34,237	39,611
Insurance claims	(3,465)	(15,578)	(22,344)
Total income, net of insurance claims	18,626	18,659	17,267
Operating expenses	(11,729)	(12,346)	(12,627)
Trading surplus	6,897	6,313	4,640
Impairment	(937)	(688)	(752)
Profit before tax	5,960	5,625	3,888

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

At 31 December 2018, the Group’s three primary operating divisions, which are also reporting segments, were: Retail; Commercial Banking; and Insurance and Wealth. Retail provides banking, mortgages, personal loans, motor finance, credit cards and other financial services to personal and small business customers. Commercial Banking provides banking and related services to business clients, from small and medium-sized entities (SMEs) to large corporates. Insurance and Wealth provides long-term savings, protection and investment products as well as general insurance products.

Profit before tax is analysed on pages 13 to 22 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group’s segments, on pages 24 to 31 on an underlying basis. The key principles adopted in the preparation of this basis of reporting are described on page 24. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group’s internal reporting based around these segments (which reflect the Group’s organisational and management structures) in order to assess performance and allocate resources; this reporting is on an underlying basis. IFRS 8, *Operating Segments* requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements in compliance with IFRS 8. The table below shows the results of Lloyds Banking Group's segments in the last three fiscal years, and their aggregation. Further information on non-GAAP measures and the reconciliations required by the Securities and Exchange Commission's Regulation G are set out on pages F-21 to F-26.

	2018	2017[1]	2016[1]
	£m	£m	£m
Retail	4,272	3,770	3,303
Commercial Banking	2,160	2,231	2,246
Insurance and Wealth	927	899	809
Other	707	728	424
Profit before tax – underlying basis	8,066	7,628	6,782

1 Segmental analysis restated, as explained on page 24.

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

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SELECTED CONSOLIDATED FINANCIAL DATA

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

	2018	2017[1]	2016[1]	2015[1]	2014[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	18,626	18,659	17,267	17,421	16,399
Operating expenses	(11,729)	(12,346)	(12,627)	(15,387)	(13,885)
Trading surplus	6,897	6,313	4,640	2,034	2,514
Impairment losses	(937)	(688)	(752)	(390)	(752)
Profit before tax	5,960	5,625	3,888	1,644	1,762
Profit for the year	4,400	3,897	2,164	956	1,499
Profit for the year attributable to ordinary shareholders	3,869	3,392	1,651	466	1,125
Dividends for the year[2,3]	2,288	2,195	2,175	1,962	535
Balance sheet data at 31 December (£m)					
Share capital	7,116	7,197	7,146	7,146	7,146
Shareholders' equity	43,434	43,551	42,670	41,234	43,335
Other equity instruments	6,491	5,355	5,355	5,355	5,355
Customer deposits	418,066	418,124	415,460	418,326	447,067
Subordinated liabilities	17,656	17,922	19,831	23,312	26,042
Loans and advances to customers	484,858	472,498	457,958	455,175	482,704
Total assets	797,598	812,109	817,793	806,688	854,896
Share information					
Basic earnings per ordinary share	**5.5p**	4.9p	2.4p	0.8p	1.7p
Diluted earnings per ordinary share	**5.5p**	4.8p	2.4p	0.8p	1.6p
Net asset value per ordinary share	**61.0p**	60.5p	59.8p	57.9p	60.7p
Dividends per ordinary share[2,4]	**3.21p**	3.05p	3.05p	2.75p	0.75p
Equivalent cents per share[1,4,5]	**4.16c**	4.06c	3.95c	4.03c	1.16c
Market price per ordinary share (year end)	**51.9p**	68.1p	62.5p	73.1p	75.8p
Number of shareholders (thousands)	2,404	2,450	2,510	2,563	2,626
Number of ordinary shares in issue (millions)[6]	71,164	71,973	71,374	71,374	71,374
Financial ratios (%)[7]					
Dividend payout ratio[8]	57.6	62.8	124.9	359.3	45.1
Post-tax return on average shareholders' equity	9.3	8.0	4.1	1.3	2.9
Post-tax return on average assets	0.54	0.48	0.26	0.11	0.17
Average shareholders' equity to average assets	5.3	5.3	5.2	5.1	4.7
Cost:income ratio[9]	63.0	66.2	73.1	88.3	84.7
Capital ratios (%)					
Total capital	22.9	21.2	21.2	21.5	22.0
Tier 1 capital	18.2	17.2	16.8	16.4	16.5
Common equity tier 1 capital/Core tier 1 capital	14.6	14.1	13.4	12.8	12.8

1 The Group has adopted IFRS 9 and IFRS 15 with effect from 1 January 2018; in accordance with the transition requirements comparative information has not been restated.

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

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

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

5 Translated into US dollars at the Noon Buying Rate on the date each payment was made, with the exception of the final dividend in respect of 2018, which has been translated at the Noon Buying Rate on 15 February 2019.

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

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

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

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

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

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

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

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

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

The Group successfully launched its new non ring-fenced bank, Lloyds Bank Corporate Markets plc in 2018, transferring in the non ring-fenced business from the rest of the Group, thereby meeting its legal requirements under ring-fencing legislation.

On 23 October 2018, the Group announced a strategic partnership with Schroders plc to create a market-leading wealth management proposition. The three key components of the partnership are: (i) the establishment of a new financial planning joint venture; (ii) the Group taking a 19.9 per cent stake in Schroders high net worth UK wealth management business; and (iii) the appointment of Schroders as the active investment manager of approximately £80 billion of the Scottish Widows and Lloyds Banking Group insurance and wealth related assets.

BUSINESS

STRATEGY OF LLOYDS BANKING GROUP

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

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

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

STRATEGIC PRIORITIES

In early 2018 the Group launched the third phase of its strategic plan. The Group identified four strategic priorities focused on the financial needs and behaviours of the customer of the future: further enhancing the Group's leading customer experience; further digitising the Group; maximising Group capabilities; and transforming ways of working. The Group will invest more than £3 billion in these strategic initiatives through the plan period that will drive the Group's transformation into a digitised, simple, low risk, customer-focused UK financial services provider.

Delivering a leading customer experience

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

– remaining the number 1 digital bank in the UK with open banking functionality;

– unrivalled reach with UK's largest branch network serving complex needs; and

– data-driven and personalised customer propositions.

Digitising the Group

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

– deeper end-to-end transformation targeting over 70 per cent of cost base;

– simplification and progressive modernisation of our data and IT infrastructure; and

– technology enabled productivity improvements across the business.

Maximising the Group's capabilities

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

– increasing Financial Planning and Retirement (FP&R) open book assets by more than £50 billion by 2020 with more than 1 million new pension customers;

– implementing an integrated FP&R proposition with single customer view; and

– start-up, SME and Mid Market net lending growth (more than £6 billion in the plan period).

Transforming ways of working

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

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

The Group's activities are organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth. In 2018 charges in relation to other conduct provisions (referred to as remediation) have been reclassified so that they are now included in underlying profit. In addition, results in relation to certain assets which are outside the Group's risk appetite, previously reported as part of run-off within Other, have been reclassified into Retail and Commercial.

Further information on the Group's segments is set out on pages 24 to 31 and in note 4 to the financial statements.

MATERIAL CONTRACTS

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

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BUSINESS

ENVIRONMENTAL MATTERS

Helping the transition to a sustainable low carbon economy

Following a Board level review of our approach to environmental sustainability, we have developed a new sustainability strategy which focuses on the opportunities and threats related to climate change and the need for the UK to transition to a sustainable low carbon economy.

This strategy supports the Task Force on Climate Related Financial Disclosures (TCFD) recommendations and incorporates an implementation plan to address them and achieve full disclosure within five years. The strategy maps to the key headings used in the TCFD framework.

STRATEGY

Our commitment

The UK is committed to the vision of a sustainable, low carbon economy, and has placed clean growth at the heart of its industrial strategy. This will require a radical reinvention of the way people, work, live and do business.

We have a unique position within the UK economy with our purpose of Helping Britain Prosper. The successful transition to a sustainable, low carbon economy that is resilient to climate change impacts and sustainably uses resources is of strategic importance to us. We support the aims of the 2015 Paris Agreement on Climate Change, and the UK Government's Clean Growth Strategy.

Our approach

To meet our commitment, we will:

Take a strategic approach to identifying new opportunities to support our customers and clients and to finance the UK transition to a sustainable low carbon economy, embedding sustainability into Group strategy across all activities
Identify and manage material sustainability and climate related risks across the Group, disclosing these and their impacts on the Group and its financial planning processes in line with the TCFD recommendations

Use our scale and reach to help drive progress towards a sustainable and resilient UK economy, environment and society through our engagement with industry, Government, investors, suppliers and customers
Embed sustainability into the way we do business and manage our own operations in a more sustainable way

Our ambition

Our goal is to be a leader in supporting the UK to successfully transition to a more sustainable, low carbon economy. We have set ourselves seven ambitions anchored to the goals laid out in the UK Government's Clean Growth Strategy, as these align closely to our business priorities:

Business: become a leading UK commercial bank for sustainable growth, supporting our clients to transition to sustainable business models and operations, and to pursue new clean growth opportunities
Homes: be a leading UK provider of customer support on energy efficient, sustainable homes
Vehicles: be a leading UK provider of low emission/green vehicle fleets
Pensions & investments: be a leading UK pension provider that offers our customers and colleagues sustainable investment choices, and challenges companies we invest in to behave more sustainably and responsibly
Insurance: be a leading UK insurer in improving the resilience of customers' lives against extreme weather caused by climate change
Green bonds: be a leading UK bank in the green/sustainable bonds market
Our Own Footprint: be a leading UK bank in reducing our own carbon footprint and challenging our suppliers to ensure our own consumption of resources, goods and services is sustainable
For each ambition we will consider the Government's targets and current plans.

We will use forward looking scenarios to identify risks and opportunities over short, medium and long term time horizons and assess how they impact the resilience of our strategy. We are developing a series of propositions against each ambition and have defined an implementation plan to achieve a leadership position within three years. We will work with Government and other stakeholders on thought leadership to help inform the creation of the policies and market conditions required for large scale investment in the transition to a sustainable, low carbon economy. To support these propositions, we are equipping our business relationship managers and other colleagues with training and tools to have more informed conversations on climate related issues. As part of our TCFD implementation plan, we will also develop a forward looking approach to systematically reporting material financial risk and opportunity aggregated across the Group.

Improving our own environmental footprint is an important foundation for our activity. We've consistently reduced our environmental impacts, thanks to the ambitious Environmental Action Plan we launched in 2010. To ensure this plan supports the UK's climate change priorities and our long term strategy, we have a set of market leading targets to improve the sustainability of our own operations and supply chain. These include reducing our operational waste by 70 per cent by 2020 and 80 per cent by 2025 (compared to 2014/15), and reducing our CO_2e by 60 per cent by 2030 and 80 per cent by 2050 (compared to 2009) www.lloydsbankinggroup.com/our-group/responsible-business/sustainability-in-lloyds-banking-group. We anticipate achievement of the 2050 target well before this date, driven by both our energy efficiency improvements, direct investment in renewable energy on our sites and through purchasing Renewable Energy Guarantees of Origin (REGOs) to cover our UK electricity consumption. We are now able to state that 100 per cent of our UK electricity comes from renewable sources and to show our commitment to supporting the transition to the low carbon economy, we have joined the RE100 campaign, a collaborative, global initiative uniting businesses committed to 100 per cent renewable energy.

Governance

We have established a dedicated governance process to provide oversight and ownership of the sustainability strategy. This includes the Responsible Business Committee (RBC), a sub-committee of the Board, which meets quarterly and provides Board level oversight. This committee is chaired by Sara Weller, Group Non-Executive Director and includes the Chairman, Lord Blackwell as a member. At Executive level, we have established a Group Executive Sustainability Committee (GESC), which is a sub-committee of our Group Executive Committee (GEC) and provides oversight and recommends decisions to the GEC. The RBC, GEC and GESC have all been informed on key climate related issues by external industry experts.

We have created a Group sustainability team, supported by divisional Governance Forums and working groups led by divisional Managing Directors. This enables us to have a coordinated approach to oversight, delivery and reporting of the Group sustainability strategy to the GESC, along with a mechanism for keeping management and the Board updated on climate related issues impacting the Group.

For the implementation of the TCFD recommendations across the Group, we have established a senior executive group TCFD forum. We aim to expand the consideration of sustainability and climate related issues into relevant Board and governance committees including processes to monitor and oversee progress against goals and targets related to climate issues. We will also consider how sustainability might be incorporated into our remuneration policies.

Risk Management

Each division within the Group is responsible for identifying and prioritising relevant climate related risks and opportunities and integrating them into their risk management processes, which determine materiality and classify risks into traditional risk categories. This includes identifying potential risks through horizon scanning of changes in regulation, technology and consumer demand. Risks are classified in terms of whether they impact the Group in the short, medium or long term. Examples include possible changes in the sustainability of homes, how vehicles are powered, changes in UK energy mix, through to changes in the frequency and severity of extreme weather events. The Group sustainability team facilitates collaboration across divisions to increase understanding of consistent issues, as well as our risk, opportunities and financial impact on an aggregated basis.

During 2018, we reviewed our external sector statements to confirm that they align to our sustainability strategy and consider appropriate climate related risk. We introduced a position statement for coal and revised statements for defence, mining, oil and gas, power, and forestry. For more information on our sector statements www.lloydsbankinggroup.com/our-group/responsible-business/sustainability-in-lloyds-banking-group. In 2019, we will review these statements again, and consider developing statements for other sectors and topics. We will review ways to embed sustainability in the Group’s key policies.

Forward looking scenario analysis incorporating physical and transition risk will be utilised across the Group to systematically identify risks and opportunities. During 2018, Commercial Banking undertook forward looking scenario analyses including business as usual and low carbon transition scenarios, identifying sectors with a higher level of climate related risk and opportunity. Detailed assessments are now being undertaken on higher risk sectors to understand the potential financial impact to our customers and to the Group. We will be completing further reviews of higher risk sectors in 2019 to inform portfolio analytics, counterparty risk and financial product development, while increasing the scope to also include other divisions.

Metrics and Targets

As part of our TCFD implementation plan we are developing our approach to reporting metrics and targets. This will include a long term reporting framework, enabling us to track our performance against our sustainability strategy, and disclose the financial impact of climate change related risks and opportunities. We will define metrics linked to our green finance propositions and the carbon exposure of our activities. Our targets will have specific time horizons against defined baseline years and will consider the level of historical and forward looking projections that can be made available. We aim to develop this new reporting framework in the first half of 2019 and will start to include key quantified metrics in our next annual report.

We have made sustainability a focus area in our Helping Britain Prosper Plan and have defined metrics for it. We disclose our in-house greenhouse gas emissions, as shown below, and our set of in house environmental targets on our website www.lloydsbankinggroup.com/our-group/responsible-business/ sustainability-in-lloyds-banking-group.

Clean Growth Finance Initiative

In 2018 we launched a £2 billion Clean Growth Finance Initiative (CGFI) to help British businesses reduce their environmental impacts and benefit from the transition to a low carbon economy. The CGFI aims to be the most inclusive UK green funding proposition available, incentivising all types of businesses to invest in low carbon projects by providing discounted financing for capital expenditure or investment with a green purpose.

CO_2 emissions (tonnes)	**Oct 17-Sept 18**	Oct 16-Sept 17	Oct 15-Sept 16[1]
Total CO_2e (market-based)	115,467	303,065	340,261[2]
Total CO_2e (location-based)	244,407	286,892	340,261
Total Scope 1	48,461	51,419	53,023
Total Scope 2 (market-based)	1,976	178,771	202,319[2]
Total Scope 2 (location-based)	130,916	162,598	202,319
Total Scope 3	65,030	72,876	84,918

1 Restated 2017/2016 and 2016/2015 emissions data to improve the accuracy of reporting, using actual data to replace estimates.

2 Note our market based emissions are equal to location based for 2016/15. This is in accordance with GHG protocol guidelines in absence of appropriate residual factors.

Emissions in tonnes CO_2e in line with the GHG Protocol Corporate Standard (2004). We are now reporting to the revised Scope 2 guidance, disclosing a market-based figure in addition to the location-based figure. The measure and reporting criteria for Scope 1, 2, 3 emissions is provided in the Lloyds Banking Group Reporting Criteria statement available online at
www.lloydsbankinggroup.com/ResponsibleBusiness

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

Scope 2 emissions have been calculated in accordance with GHG Protocol guidelines, in both location and market based methodologies.

Indicator is subject to Limited ISAE3000 (revised) assurance by Deloitte LLP for the 2018 Annual Responsible Business Reporting. Deloitte's 2018 assurance statement and the 2018 Reporting Criteria are available online at www.lloydsbankinggroup.com/our-group/responsible-business

PROPERTIES

At 31 December 2018, Lloyds Banking Group occupied 1,891 properties in the UK. Of these, 405 were held as freeholds and 1,486 as leasehold. The majority of these properties are retail branches, widely distributed throughout England, Scotland, Wales and Northern Ireland. Other buildings include the Lloyds Banking Group's head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations – London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 114 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis.

LEGAL ACTIONS AND REGULATORY MATTERS

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

PAYMENT PROTECTION INSURANCE (EXCLUDING MBNA)

The Group increased the provision for PPI costs by a further £750 million in the year ended 31 December 2018, of which £200 million was in the fourth quarter, bringing the total amount provided to £19,425 million.

The charge in 2018 related to a number of factors including higher expected complaint volumes, which increased to 13,000 per week, and associated administration costs, an increase in average redress per complaint, additional operational costs to deal with potential complaint volatility and continued improvements in data interrogation and the Group's ability to identify valid complaints. The remaining provision is consistent with an average of approximately 13,000 complaints per week to the industry deadline of the end of August 2019.

At 31 December 2018, a provision of £1,329 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £1,859 million during the year ended 31 December 2018.

Sensitivities

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

The total amount provided for PPI represents the Group's best estimate of the likely future cost. However a number of risks and uncertainties remain including with respect to future complaint volumes. The cost could differ from the Group's estimates and the assumptions underpinning them, and could result in a further provision being required. There is also uncertainty around the impact of the regulatory changes, Financial Conduct Authority media campaign and Claims Management Company and customer activity, and potential additional remediation arising from the continuous improvement of the Group's operational practices.

For every additional 1,000 reactive complaints per week above 13,000 on average from January 2019 through to the industry deadline of the end of August 2019, the Group would expect an additional charge of approximately £85 million.

PAYMENT PROTECTION INSURANCE (MBNA)

As announced in December 2016, the Group's exposure is capped at £240 million, which is already provided for through an indemnity received from Bank of America. MBNA increased its PPI provision by £100 million in the year ended 31 December 2018 but the Group's exposure continues to remain capped at £240 million under the arrangement with Bank of America, notwithstanding this increase by MBNA.

OTHER PROVISIONS FOR LEGAL ACTIONS AND REGULATORY MATTERS

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2018 the Group charged a further £600 million in respect of legal actions and other regulatory matters, and the unutilised balance at 31 December 2018 was £861 million (31 December 2017: £1,292 million). The most significant items are as follows.

Arrears handling related activities

The Group has provided an additional £151 million in the year ended 31 December 2018 for the costs of identifying and rectifying certain arrears management fees and activities, taking the total provided to date to £793 million. The Group has put in place a number of actions to improve its handling of customers in these areas and has made good progress in reimbursing arrears fees to impacted customers.

Packaged bank accounts

The Group has provided a further £45 million in the year ended 31 December 2018 (£245 million was provided in the year ended 31 December 2017) in respect of complaints relating to alleged mis-selling of packaged bank accounts, raising the total amount provided to £795 million. A number of risks and uncertainties remain particularly with respect to future volumes.

Customer claims in relation to insurance branch business in Germany

The Group continues to receive claims in Germany from customers relating to policies issued by Clerical Medical Investment Group Limited (subsequently renamed Scottish Widows Limited), with smaller numbers received from customers in Austria and Italy. The industry-wide issue regarding notification of contractual 'cooling off' periods continued to lead to an increasing number of claims in 2016 and 2017 levelling out in 2018. Up to 31 December 2017 the Group had provided a total of £639 million, with no further amounts provided during the year ended 31 December 2018. The validity of the claims facing the Group depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will be known only once all relevant claims have been resolved.

HBOS Reading – customer review

The Group has now completed its compensation assessment for all 71 business customers within the customer review, with more than 96 per cent of these offers accepted. In total, more than £96 million has been offered of which £78 million has so far been accepted, in addition to £9 million for ex-gratia payments and £5 million for the reimbursements of legal fees.

The review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Group in 2009. The Group has provided a further £15 million in the year ended 31 December 2018 for customer settlements, raising the total amount provided to

£115 million and is now nearing the end of the process of paying compensation to the victims of the fraud, including ex-gratia payments and reimbursements of legal fees.

INTERCHANGE FEES

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

- The European Commission continues to pursue competition investigations against Mastercard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA;
- Litigation brought by retailers continues in the English Courts against both Visa and Mastercard;
- Any ultimate impact on the Group of the above investigations and litigation against Visa and Mastercard remains uncertain at this time.

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

LIBOR AND OTHER TRADING RATES

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

Certain Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. Certain of the plaintiffs' claims, have been dismissed by the US Federal Court for Southern District of New York (subject to appeals).

Certain Group companies are also named as defendants in (i) UK based claims; and (ii) in 2 Dutch class actions, raising LIBOR manipulation allegations. A number of the claims against the Group in relation to the alleged mis-sale of interest rate hedging products also include allegations of LIBOR manipulation.

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

UK SHAREHOLDER LITIGATION

In August 2014, the Group and a number of former directors were named as defendants in a claim by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. The defendants refute all claims made. A trial commenced in the English High Court on 18 October 2017 and concluded on 5 March 2018 with judgment to follow. It is currently not possible to determine the ultimate impact on the Group (if any).

TAX AUTHORITIES

The Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013 HMRC informed the Group that their interpretation of the UK rules which allow the offset of such losses denies the claim. If HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £770 million (including interest) and a reduction in the Group's deferred tax asset of approximately £250 million. The Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due. There are a number of other open matters on which the Group is in discussion with HMRC (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc), none of which is expected to have a material impact on the financial position of the Group.

RESIDENTIAL MORTGAGE REPOSSESSIONS

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases concerning certain aspects of the Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA has been actively engaged with the industry in relation to these considerations and has published Guidance on the treatment of customers with mortgage payment shortfalls. The Guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers' monthly mortgage instalments. The Group is implementing the Guidance and has now contacted nearly all affected customers with any remaining customers anticipated to be contacted by the end of March 2019.

MORTGAGE ARREARS HANDLING ACTIVITIES – FCA INVESTIGATION

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

HBOS READING – FCA INVESTIGATION

On 7 April 2017 the FCA announced that it had resumed its investigation into the events surrounding the discovery of misconduct within the Reading-based Impaired Assets team of HBOS. The investigation is ongoing and the Group continues to cooperate with the FCA. It is not currently possible to make a reliable assessment of any liability that may result from the investigation including any financial penalty or public censure.

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CONTINGENT LIABILITIES RELATING TO OTHER LEGAL ACTIONS AND REGULATORY MATTERS

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

COMPETITIVE ENVIRONMENT

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

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

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

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

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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Highlights

Given our UK focus, the Group's prospects are closely linked to the fortunes of the UK economy.

The economy faces significant uncertainty around the UK's departure from the EU. With the expectation that the UK leaves in an orderly fashion, the economy should be able to grow in 2019 at a similar pace to 2018.

Our low risk business model and focus on efficiency positions us well irrespective of macro conditions but if the UK economy sees significant sustained deterioration this is likely to impact Group performance.

Overview

As the largest provider of UK banking services, our prospects are closely aligned to the outlook for the UK economy. In the period following the decision to leave the EU, the economy has been resilient. Growth has slowed only slightly below its trend rate, the unemployment rate has continued to fall to a 43 year low, and property prices have continued to rise slowly. This resilience is expected to continue in 2019 and the next few years, barring any sudden shocks to business or consumer confidence particularly in connection with the UK's exit from the EU during 2019.

Market dynamics

Households' spending power has been improving in recent months as pay growth has begun to pick up and outpace inflation, which is falling back towards the medium term target of 2 per cent. Inflation adjusted pay is now slightly above its previous peak in early 2016. This improvement is expected to continue through 2019, supported by a reduction in planned fiscal tightening announced in the 2018 Budget in November and the end of the cap to public sector pay growth. The improvement in spending power should help support growth in consumer spending and borrowing, whilst also increasing growth in households' savings.

The UK housing market has been broadly flat in 2018 in aggregate, although weakness has been centred around London and the South East where high prices are constraining affordability. Improved households' spending power should support the housing market in 2019, as would resolution of uncertainty about the immediate political and economic concerns.

Operational impacts of the UK's exit from the EU present risks for some of our customers' businesses. With the future trading arrangements between the UK and EU unlikely to become finalised for a few years, businesses' investment decisions are more difficult and postponement of investment may weigh on future growth capacity of the economy. Uncertainty is also challenging the UK's attractiveness to foreign investors, although many qualities that have attracted investors in the past remain.

More widely, the global economy is transitioning away from the exceptionally low interest rates in place in most advanced economies since the financial crisis. This process will not always be constant, with different countries at different stages of their economic cycle, and unwinding of 'quantitative easing' may increase volatility in financial markets. The widespread trend to increasingly populist politics, of which the US-China trade war is a prime example, poses a challenge to appropriate economic policy.

Barring sudden shocks stemming from these challenges, the UK economy is expected to grow through 2019 to 2021 at a pace similar to 2018. The unemployment rate is expected to rise only a little from its current 43 year low, and further mild increases in house prices are expected. The Bank Rate is expected to rise only slowly, as the uncertainty drag on the economy fades. Growth in many of our markets is expected to pick up, although the consumer credit market should continue to slow after its strong growth through 2014 to 2017. Impairments are expected to increase in 2019 as we continue to see lower write-backs and recoveries but remain at relatively low levels.

Our response

Given our UK focus, the Group's prospects are closely linked to the performance of the UK economy. Our low risk, stable business model and focus on efficiency positions us well to continue to support customers irrespective of macro conditions.

CRITICAL ACCOUNTING POLICIES

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

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

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group's IFRS reporting are discussed in note 56 to the financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS – 2018, 2017 AND 2016

SUMMARY

	2018	2017	2016
	£m	£m	£m
Net interest income	**13,396**	10,912	9,274
Other income	**8,695**	23,325	30,337
Total income	**22,091**	34,237	39,611
Insurance claims	**(3,465)**	(15,578)	(22,344)
Total income, net of insurance claims	**18,626**	18,659	17,267
Operating expenses	**(11,729)**	(12,346)	(12,627)
Trading surplus	**6,897**	6,313	4,640
Impairment	**(937)**	(688)	(752)
Profit before tax	**5,960**	5,625	3,888
Tax expense	**(1,560)**	(1,728)	(1,724)
Profit for the year	**4,400**	3,897	2,164
Profit attributable to ordinary shareholders	**3,869**	3,392	1,651
Profit attributable to other equity holders[1]	**433**	415	412
Profit attributable to equity holders	**4,302**	3,807	2,063
Profit attributable to non-controlling interests	**98**	90	101
Profit for the year	**4,400**	3,897	2,164

1 The profit after tax attributable to other equity holders of £433 million (2017: £415 million; 2016: £412 million) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £106 million (2017: £102 million; 2016: £91 million).

2018 COMPARED WITH 2017

During the year ended 31 December 2018, the Group recorded a profit before tax of £5,960 million, an increase of £335 million, or 6 per cent, compared with a profit before tax in 2017 of £5,625 million.

Total income, net of insurance claims, decreased by £33 million to £18,626 million in 2018 compared with £18,659 million in 2017, comprising a £2,517 million decrease in other income, net of insurance claims, largely offset by an increase of £2,484 million in net interest income.

Net interest income was £13,396 million in 2018; an increase of £2,484 million, or 23 per cent compared to £10,912 million in 2017. There was a significant reduction in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group from an expense of £1,435 million in 2017 to a credit of £844 million in 2018. This decrease reflects the relatively poor investment performance of the consolidated OEICs in the year, with losses on debt securities and equities. FTSE All Share investments returned losses of 9.5 per cent over 2018 compared to gains of 13.1 per cent over 2017 and sterling corporates returned losses of 2.3 per cent compared to gains of 5.2 per cent in 2017. The change in population of consolidated OEICs in 2018 compared to 2017 did not have a significant impact. After adjusting for this, net interest income was £205 million, or 2 per cent higher. Average interest-earning assets decreased by £5,153 million, or 1 per cent, to £580,221 million in 2018 compared to £585,374 million in 2017 as growth in targeted segments has been more than offset by the impact of the sale of the Group's Irish mortgage portfolio and reductions in the closed mortgage book. The net interest margin improved, excluding the impact of amounts payable to OEIC unitholders, as a result of lower deposit costs and hedging benefits more than offsetting continued pressure on asset margins.

Other income, net of insurance claims, was £2,517 million, or 32 per cent, lower at £5,230 million in 2018 compared to £7,747 million in 2017. There were substantially reduced gains within trading income on policyholder assets in the insurance business, as a result of market performance over the year, particularly in equities, but this was offset by a lower level of insurance claims. Insurance claims expense was £12,113 million lower at £3,465 million in 2018 compared to £15,578 million in 2017. The insurance claims expense in respect of life and pensions business was £12,111 million lower at £3,130 million in 2018 compared to a charge of £15,241 million in 2017. Insurance claims in respect of general insurance business were £2 million or 1 per cent, lower at £335 million in 2018 compared to £337 million in 2017.

Fee and commission income was £117 million or 4 per cent, lower at £2,848 million compared to £2,965 million in 2017 as increased levels of card fees, reflecting both the inclusion of MBNA for a full year and higher levels of card usage, were more than offset by lower current account fees, reflecting reduced volumes of added-value accounts and changes in pricing structure. Fee and commission expense increased by £4 million to £1,386 million compared with £1,382 million in 2017. Net trading income decreased by £15,693 million to a deficit of £3,876 million in 2018 driven by reduced gains on policyholder assets. Insurance premium income was £1,259 million, or 16 per cent, higher at £9,189 million in 2018 compared with £7,930 million in 2017; there was an increase of £1,332 million in life insurance premiums offset by a £73 million decrease in general insurance premiums. The increase in life insurance premiums reflects higher levels of bulk annuity deals and business growth. General insurance premiums decreased as a result of reduced new business and the continued run-off of closed books. Other operating income was £75 million, or 4 per cent, lower at £1,920 million in 2018 compared to £1,995 million in 2017.

Operating expenses decreased by £617 million, or 5 per cent to £11,729 million in 2018 compared with £12,346 million in 2017 reflecting a reduction of £815 million in charges for redress payments to customers in respect of PPI and other conduct related matters from £2,165 million in 2017 to £1,350 million in 2018. Excluding these charges from both years, operating expenses were £198 million, or 2 per cent, higher at £10,379 million in 2018 compared to £10,181 million in 2017 as increased restructuring costs and the impact of the ownership of MBNA for a full year in 2018 have more than offset the operating cost savings driven by increased efficiency from digitalisation and process improvements. Staff costs were £152 million, or 3 per cent, higher at £4,762 million in 2018 compared with £4,610 million in 2017; as cost savings arising from headcount reductions have been offset by increased

pension charges and redundancy costs. Premises and equipment costs were £1 million lower at £729 million in 2018 compared with £730 million in 2017. Other expenses were £20 million, or 1 per cent, higher at £2,483 million in 2018 compared with £2,463 million in 2017. Depreciation and amortisation costs were £35 million, or 1 per cent, higher at £2,405 million in 2018 compared to £2,370 million in 2017, as reduced charges in respect of property, plant and equipment were more than offset by increased charges relating to intangible assets, reflecting increased investment in software.

Impairment losses increased by £249 million, or 36 per cent, to £937 million in 2018 compared with £688 million in 2017. Impairment losses in respect of loans and advances to customers were £325 million, or 47 per cent, higher at £1,022 million in 2018 compared with £697 million in 2017; this includes the impact of a full year charge for the MBNA business, acquired part way through 2017, and lower levels of releases and write-backs than in 2017. There was a credit of £73 million in respect of undrawn commitments in 2018, compared to a credit of £9 million in 2017.

In 2018, the Group recorded a tax expense of £1,560 million compared to a tax expense of £1,728 million in 2017. The effective tax rate was 26.2 per cent, compared to the standard UK corporation tax rate of 19.0 per cent. The higher rate was principally as a result of the banking surcharge and restrictions on the deductibility of conduct provisions, more than offsetting the benefit of tax-exempt gains.

Total assets were £14,511 million, or 2 per cent, lower at £797,598 million at 31 December 2018 compared to £812,109 million at 31 December 2017. After adjusting for the impact of adoption of IFRS 9, which required the reclassification of certain lending assets to fair value through profit or loss, loans and advances to customers increased in the year by £23,842 million to £484,858 million, compared to £461,016 million at 1 January 2018, mainly as a result of a £23,651 million increase in holdings of reverse repurchase agreement balances, as part of a rebalancing of the Group’s liquid asset portfolio. There was continued growth in targeted segments such as SME and motor finance which more than offset a reduction of some £4 billion on sale of the Group’s Irish residential mortgage portfolio; the open mortgage book was broadly flat reflecting continued focus on margin in a highly competitive market environment. Financial assets held at fair value through profit or loss decreased by £17,479 million, after taking into account the transition to IFRS 9, largely as a result of adverse market movements on policyholder assets in the insurance business. Financial assets held at fair value through other comprehensive income have reduced by £18,102 million since the start of 2018 following sales of some of the Group’s gilt holdings, as part of the rebalancing of the Group’s liquid asset portfolio.

Customer deposits were little changed at £418,066 million at 31 December 2018 compared to £418,124 million at 31 December 2017 as an £820 million reduction in repurchase agreement balances and reductions in maturing retail savings products have largely offset growth in retail current account balances and in Commercial Banking. Financial liabilities at fair value through profit or loss were £20,330 million, or 40 per cent, lower at £30,547 million at 31 December 2018 compared to £50,877 million at 31 December 2017 following reductions in trading book repurchase agreements, a result of growth in other funding sources. Debt securities in issue were £18,718 million higher at £91,168 million at 31 December 2018 compared to £72,450 million at 31 December 2017 following new issuances to maintain funding levels at relatively attractive rates. Insurance and investment contract liabilities have fallen by £6,133 million, or 5 per cent, from £118,860 million at 31 December 2017 to £112,727 million at 31 December 2018 as new business flows have been more than offset by the impact of adverse market performance on investment values.

Total equity has increased by £1,056 million, or 2 per cent, despite a reduction of £1,005 million as a result of the Group's share buyback programme. There was a reduction of £1,191 million on implementation of IFRS 9 and IFRS 15 but this has been more than offset by retained profits, after dividends; and the issue of £1,136 million of Additional Tier 1 securities.

The Group's common equity tier 1 (CET1) capital ratio has strengthened to 14.6 per cent (31 December 2017: 14.1 per cent; 1 January 2018: 14.0 per cent) primarily driven by retained profit, dividends received from the Insurance business and the reduction in risk-weighted assets. The total capital ratio increased to 22.9 per cent (31 December 2017: 21.2 per cent; 1 January 2018: 21.2 per cent), primarily reflecting the increase in CET1 capital, the reduction in risk-weighted assets, the issuance of Additional Tier 1 securities and dated subordinated debt instruments and foreign exchange movements on subordinated debt instruments, partially offset by the amortisation of dated instruments and the reduction in the transitional limit applied to grandfathered Additional Tier 1 securities.

Risk-weighted assets reduced by £4,553 million, or 2 per cent, to £206,366 million (31 December 2017: £210,919 million), largely reflecting the sale of the Irish mortgage portfolio. The UK leverage ratio increased to 5.5 per cent (31 December 2017: 5.3 per cent; 1 January 2018: 5.3 per cent), primarily as a result of the issuance of the Additional Tier 1 securities.

The Group's liquidity surplus continues to exceed the regulatory minimum and internal risk appetite with the liquidity coverage ratio at 130 per cent (31 December 2017: 127 per cent).

The Group has recommended a final ordinary dividend of 2.14 pence per share (2017: 2.05 pence per share). This is in addition to the interim ordinary dividend of 1.07 pence per share (2017: 1.0 pence per share) that was paid in September 2018. The total ordinary dividend per share for 2018 of 3.21 pence per share has increased by 5 per cent, from 3.05 pence in 2017.

The Group is planning on the basis of an orderly EU withdrawal and, given the resilience of the UK economy, intends to implement a share buyback of up to £1.75 billion (2017: £1 billion) which will commence in March 2019 and is expected to be completed by 31 December 2019. The Group's current preference is to return surplus capital by way of a buyback programme given the amount of surplus capital, the normalisation of ordinary dividends, and the flexibility that a buyback programme offers.

2017 COMPARED WITH 2016

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

NET INTEREST INCOME

	2018	2017	2016
Net interest income £m	13,396	10,912	9,274
Average interest-earning assets £m	580,221	585,374	600,435
Average rates:			
Gross yield on interest-earning assets %[1]	2.82	2.73	2.77
Interest spread %[2]	2.22	1.67	1.33
Net interest margin %[3]	2.31	1.86	1.54

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.

2018 COMPARED WITH 2017

Net interest income was £13,396 million in 2018, an increase of £2,484 million, or 23 per cent, compared to £10,912 million in 2017. Net interest income in 2018 includes a credit of £844 million in respect of amounts attributable to third party investors in respect of its consolidated Open-Ended Investment Companies (OEICs) compared to a charge in 2017 of £1,435 million as a result of negative market movements during 2018; the change in population of consolidated OEICs in 2018 compared to 2017 did not have a significant impact. After adjusting for the amounts payable to unitholders, net interest income was £205 million, or 2 per cent, higher at £12,552 million in 2018 compared to £12,347 million in 2017.

Average interest-earning assets were £5,153 million, or 1 per cent, lower at £580,221 million in 2018 compared to £585,374 million in 2017. The decrease reflects the sale of the Group's Irish mortgage book and reductions in the closed mortgage book and in the portfolio of assets which are outside of the Group's risk appetite, more than offsetting the impact of a full year's ownership of MBNA and growth in SME and mid-markets lending and in Motor Finance. Average interest-earning assets in Retail were £3,792 million, or 1 per cent, higher at £342,328 million in 2018 compared to £338,536 million in 2017 and average relationship lending and similar interest-earning assets in Commercial Banking were £155 million higher at £91,230 million in 2018 compared to £91,075 million in 2017. Average interest-earning assets across the rest of the Group were £9,100 million, or 6 per cent, lower at £146,663 million in 2018 compared to £155,763 million in 2017.

The net interest margin was 45 basis points higher at 2.31 per cent in 2018 compared to 1.86 per cent in 2017, and adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 5 basis points higher at 2.16 per cent in 2018 compared to 2.11 per cent in 2017. The improvement in net interest margin reflected lower deposit costs and an increased contribution from the structural hedge, more than offsetting continued pressure on asset margins. Margins in Retail improved with the benefits of a full year of MBNA and lower funding costs more than offsetting ongoing mortgage pricing pressure. Margins on relationship lending and similar interest-earning assets in Commercial Banking were stable.

2017 COMPARED WITH 2016

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

Average interest-earning assets were £15,061 million, or 3 per cent, lower at £585,374 million in 2017 compared to £600,435 million in 2016. The decrease reflected the impact of reductions in closed mortgage books, lending to global corporates and in the portfolio of assets which are outside of the Group's risk appetite, more than offsetting the impact of the acquisition of MBNA. Average interest-earning assets in Retail were £2,871 million, or 1 per cent, higher at £338,536 million in 2017 compared to £335,665 million in 2016 and average interest-earning assets in Commercial Banking were £3,920 million, or 4 per cent, lower at £91,075 million in 2017 compared to £94,995 million in 2016. Average interest-earning assets across the rest of the Group were £14,012 million, or 8 per cent, lower at £155,763 million in 2017 compared to £169,775 million in 2016.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER INCOME

	2018 £m	2017 £m	2016 £m
Fee and commission income:			
Current account fees	650	712	752
Credit and debit card fees	993	953	875
Commercial banking and treasury fees	305	321	303
Unit trust and insurance broking	221	224	244
Private banking and asset management	97	98	99
Factoring	83	91	112
Other fees and commissions	499	566	660
	2,848	2,965	3,045
Fee and commission expense	(1,386)	(1,382)	(1,356)
Net fee and commission income	1,462	1,583	1,689
Net trading income	(3,876)	11,817	18,545
Insurance premium income	9,189	7,930	8,068
Gains on sale of financial assets at fair value through other comprehensive income (2017 and 2016: available-for-sale financial assets)	275	446	575
Liability management	–	(14)	(598)
Other	1,645	1,563	2,058
Other operating income	1,920	1,995	2,035
Total other income	8,695	23,325	30,337

2018 COMPARED WITH 2017

Other income was £14,630 million, or 63 per cent, lower at £8,695 million in 2018 compared to £23,325 million in 2017.

Fee and commission income was £117 million, or 4 per cent, lower at £2,848 million in 2018 compared with £2,965 million in 2017. Current account fees were £62 million, or 9 per cent, lower at £650 million in 2018 compared to £712 million in 2017, due to lower volumes of added-value accounts and changes in pricing structure. An increase of £40 million, or 4 per cent, in credit and debit card fees from £953 million in 2017 to £993 million in 2018 resulted from the inclusion of MBNA for a full year and higher levels of card usage. Commercial banking and treasury fees were £16 million, or 5 per cent, lower at £305 million in 2018 compared to £321 million in 2017 and other fees and commissions receivable were £67 million, or 12 per cent, lower at £499 million in 2018 compared to £566 million in 2017.

Fee and commission expense was £4 million, higher at £1,386 million in 2018 compared to £1,382 million in 2017 as increased credit and debit card fees payable, in part reflecting the full year impact of MBNA, have more than offset reductions in value-added account package costs and other fees payable.

Net trading income was £15,693 million, lower at a deficit of £3,876 million in 2018 compared with income of £11,817 million in 2017. Net trading income within the insurance businesses was £15,971 million, lower at a deficit of £5,030 million in 2018 compared to gains of £10,941 million in 2017, which reflects market losses in 2018 on both debt security and equity investments. Net trading income within the Group's banking activities was £278 million, or 32 per cent, higher at £1,154 million in 2018 compared to £876 million in 2017, reflecting gains on interest rate derivatives and foreign exchange contracts in the banking book not mitigated through hedge accounting.

Insurance premium income was £9,189 million in 2018 compared with £7,930 million in 2017; an increase of £1,259 million, or 16 per cent. Earned premiums in respect of the Group's long-term life and pensions business were £1,332 million, or 19 per cent, higher at £8,519 million in 2018 compared to £7,187 million in 2017 reflecting an increased level of bulk annuity deals in 2018 and growth in the corporate pensions product. General insurance earned premiums were £73 million, or 10 per cent, lower at £670 million in 2018 compared with £743 million in 2017 as a result of reduced new business and the continued run-off of closed books.

Other operating income was £75 million, or 4 per cent, lower at £1,920 million in 2018 compared to £1,995 million in 2017 as an improvement of £110 million in the movement in value of in-force business was offset by a loss of £105 million on the sale of the Group's Irish mortgage portfolio. Gains on sale of financial assets held at fair value through other comprehensive income in 2018 include a gain of £270 million on sales of UK government securities; gains on sales of available-for-sale financial assets in 2017 included a gain of £146 million on the sale of the Group's investment in Vocalink and £274 million from the sale of UK government securities.

2017 COMPARED WITH 2016

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

Fee and commission income was £80 million, or 3 per cent, lower at £2,965 million in 2017 compared with £3,045 million in 2016. Current account fees were £40 million, or 5 per cent, lower at £712 million in 2017 compared to £752 million in 2016, due to lower volumes of added-value accounts and changes in pricing structure. An increase of £78 million, or 9 per cent, in credit and debit card fees from £875 million in 2016 to £953 million in 2017 resulted from the acquisition of MBNA and higher levels of card usage. Commercial banking and treasury fees were £18 million, or 6 per cent, higher at £321 million in 2017 compared to £303 million in 2016, but this was more than offset by a £20 million reduction in unit trust and insurance broking fees and a £21 million reduction in factoring income. Other fees and commissions receivable were £94 million, or 14 per cent, lower at £566 million in 2017 compared with £660 million in 2016.

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

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

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

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

OPERATING EXPENSES

	2018 £m	2017 £m	2016 £m
Administrative expenses:			
Staff:			
Salaries	2,482	2,679	2,750
Performance-based compensation	509	473	475
Social security costs	343	361	363
Pensions and other post-retirement benefit schemes	705	625	555
Restructuring costs	249	24	241
Other staff costs	474	448	433
	4,762	4,610	4,817
Premises and equipment:			
Rent and rates	370	365	365
Repairs and maintenance	190	231	187
Other	169	134	120
	729	730	672
Other expenses:			
Communications and data processing	1,121	882	848
Advertising and promotion	197	208	198
Professional fees	287	328	265
UK bank levy	225	231	200
Other	653	814	873
	2,483	2,463	2,384
Depreciation and amortisation:			
Depreciation of tangible fixed assets	1,852	1,944	1,761
Amortisation of acquired value of in-force non-participating investment contracts	40	34	37
Amortisation of other intangible assets	513	392	582
	2,405	2,370	2,380
Goodwill impairment	–	8	–
Total operating expenses, excluding regulatory provisions	10,379	10,181	10,253
Regulatory provisions:			
Payment protection insurance provision	750	1,300	1,350
Other regulatory provisions[1]	600	865	1,024
	1,350	2,165	2,374
Total operating expenses	11,729	12,346	12,627
Cost:income ratio (%)[2]	63.0	66.2	73.1

1 In 2016, regulatory provisions of £61 million were charged against income.

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

2018 COMPARED WITH 2017

Operating expenses decreased by £617 million, or 5 per cent, to £11,729 million in 2018 compared with £12,346 million in 2017. This decrease being principally due to the reduction in the charge for conduct related matters; 2018 includes a regulatory provisions charge of £1,350 million, which was £815 million, or 38 per cent, lower than the charge of £2,165 million in 2017.

Staff costs were £152 million, or 3 per cent, higher in 2018 at £4,762 million compared to £4,610 million in 2017. On a full-time equivalent basis, the Group had 64,928 employees at the end of 2018, a reduction of 2,977 from 67,905 employees at 31 December 2017 representing an underlying reduction of 3,167 employees offset by an increase of 190 employees as a result of the acquisition of the Zurich workplace pensions business. Salaries were £197 million, or 7 per cent, lower at £2,482 million in 2018 compared with £2,679 million in 2017 as the benefit of the underlying reduction in staff numbers has more than offset the effect of annual pay rises, the acquisition of the Zurich work place pensions business and a full year's ownership of MBNA. Pension costs were £80 million, or 13 per cent, higher at £705 million in 2018 compared to £625 million in 2017 and include a past service charge of £108 million following legal clarification of requirements regarding Guaranteed Minimum Pension benefits. Social security costs were £18 million, or 5 per cent, lower at £343 million in 2018 compared with £361 million in 2017, in line with the lower salary levels. Restructuring costs were £225 million higher at £249 million in 2018 compared to £24 million in 2017 reflecting charges in relation to the Group's strategic investment plans and other staff costs were £26 million, or 6 per cent, higher at £474 million in 2018 compared with £448 million in 2017.

Premises and equipment costs were little changed at £729 million in 2018 compared to £730 million in 2017. Rent and rates were £5 million, or 1 per cent, higher at £370 million in 2018 compared to £365 million in 2017; repairs and maintenance costs were £41 million, or 18 per cent, lower at £190 million in 2018 compared to £231 million in 2017, as a result of equipment now being provided and maintained by a third party, and other premises and equipment costs increased by £35 million, or 26 per cent, from £134 million in 2017 to £169 million in 2018 reflecting a lower level of gains on disposal of premises and other fixed assets.

Other expenses, excluding the regulatory provisions charges, were £20 million, or 1 per cent, higher at £2,483 million in 2018 compared with £2,463 million in 2017. Communications and data processing costs were £239 million, or 27 per cent, higher at £1,121 million in 2018 compared with £882 million in 2017 as a result of the integration of MBNA, increased costs relating to the Group's ring-fencing programme and the Group's digitalisation initiatives. Professional fees were £41 million, or 13 per cent, lower at £287 million in 2018 compared to £328 million in 2017 and advertising and promotion costs were £11 million, or 5 per cent, lower at £197 million in 2018 compared with £208 million in 2017. The cost of the Bank levy was £6 million, or 3 per cent, lower at £225 million in 2018 compared to £231 million in 2017. Other costs were £161 million, or 20 per cent, lower at £653 million in 2018 compared with £814 million in 2017.

Depreciation and amortisation costs were £35 million, or 1 per cent, higher at £2,405 million in 2018 compared with £2,370 million in 2017. Charges for the depreciation of tangible fixed assets were £92 million, or 5 per cent, lower at £1,852 million in 2018 compared to £1,944 million in 2017, following a reduced level of operating lease additions. The charge for the amortisation of intangible assets was £121 million, or 31 per cent, higher at £513 million in 2018 compared to £392 million in 2017, reflecting a full year charge relating to the purchased credit card receivable established on the MBNA acquisition and the impact of increased levels of software capitalisation.

The Group incurred a regulatory provisions charge in operating expenses of £1,350 million in 2018 compared to £2,165 million in 2017 of which £750 million (2017: £1,300 million) related to payment protection insurance; this charge was largely driven by an increase in average redress per case, additional operational costs to deal with potential complaint volatility and continued improvements in data interrogation and the Group's ability to identify valid claims. Reactive complaint volumes have been 12,000 per week in the second half of 2018, compared with the Group's assumption of 13,000 per week. The outstanding balance sheet provision at 31 December 2018, excluding the provision in MBNA, was £1,329 million and continues to assume around 13,000 complaints per week until the time-bar in August 2019. The charge in relation to other conduct issues was £600 million in 2018, compared to £865 million in 2017; this charge included £151 million (2017: £245 million) in respect of arrears handling activities and £45 million (2017: £245 million) relating to packaged bank accounts.

2017 COMPARED WITH 2016

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

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

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

Other expenses, excluding the regulatory provisions charges, were 79 million, or 3 per cent, higher at £2,463 million in 2017 compared with £2,384 million in 2016. Communications and data processing costs were £34 million, or 4 per cent, higher at £882 million in 2017 compared with £848 million in 2016 as a result of the acquisition of MBNA and project costs; professional fees were £63 million, or 24 per cent, higher at £328 million in 2017 compared to £265 million in 2016 as a result of costs in relation to regulatory developments such as ring-fencing; and advertising and promotion costs were £10 million, or 5 per cent, higher at £208 million in 2017 compared with £198 million in 2016, in part reflecting the acquisition of MBNA. The cost of the Bank levy was £31 million, or 16 per cent, higher at £231 million in 2017 compared to £200 million in 2016. Other costs were £59 million, or 7 per cent, lower at £814 million in 2017 compared with £873 million in 2016.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

	2018 **£m**	2017 £m	2016 £m
Impairment losses on financial assets carried at amortised cost			
Loans and advances to banks	**1**	–	–
Loans and advances to customers	**1,022**	697	592
Debt securities	**–**	(6)	–
Other assets	**1**	–	–
Total impairment losses on financial assets carried at amortised cost	**1,024**	691	592
Impairment of financial assets carried at fair value through other comprehensive income (2017 and 2016: available-for-sale financial assets)	**(14)**	6	173
Loan commitments and financial guarantees (2017 and 2016: other credit risk provisions)	**(73)**	(9)	(13)
Total impairment charged to the income statement	**937**	688	752

The Group has adopted IFRS 9 with effect from 1 January 2018 and, in accordance with the transition requirements of IFRS 9, comparatives have not been restated.

2018 COMPARED WITH 2017

Impairment losses increased by £249 million, or 36 per cent, to £937 million in 2018 compared to £688 million in 2017. Credit quality remains strong with no deterioration in credit risk. The Group’s loan portfolios continue to be well positioned, reflecting the Group’s continued prudent, through the cycle approach to credit risk, and benefiting from continued low interest rates and a resilient UK economy.

The impairment charge in respect of loans and advances to customers was £325 million, or 47 per cent, higher at £1,022 million in 2018 compared to £697 million in 2017. In Retail, overall credit performance in the UK mortgage book remains strong with average mortgage loan to value ratios broadly stable at 44.1 per cent and new to arrears as a proportion of total book remaining low. New business average loan to value was 62.5 per cent and around 88 per cent of the portfolio continues to have loan to value ratios of less than 80 per cent. The consumer finance portfolios continue to perform well with credit card business new to arrears as a proportion of total book remaining low whilst the UK motor finance book continues to benefit from the Group’s conservative approach to residual values and resilient used car prices. In Commercial Banking, the book continues to benefit from effective risk management, including reduced single name and key sector exposures. Together with a resilient economic environment, this has resulted in impairment charges remaining at a low level.

There was an impairment credit in respect of financial assets held at fair value through other comprehensive income in 2018 of £14 million, compared to an impairment charge in respect of available-for-sale financial assets of £6 million in 2017. There was a credit of £73 million (2017: credit of £9 million) in respect of other credit risk provisions.

2017 COMPARED WITH 2016

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

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

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

TAXATION

	2018 £m	2017 £m	2016 £m
UK corporation tax:			
Current tax on profits for the year	**(1,386)**	(1,346)	(1,010)
Adjustments in respect of prior years	**11**	126	156
	(1,375)	(1,220)	(854)
Foreign tax:			
Current tax on profits for the year	**(34)**	(40)	(20)
Adjustments in respect of prior years	**5**	10	2
	(29)	(30)	(18)
Current tax charge	**(1,404)**	(1,250)	(872)
Deferred tax	**(156)**	(478)	(852)
Tax expense	**(1,560)**	(1,728)	(1,724)

2018 COMPARED WITH 2017

In 2018, a tax expense of £1,560 million arose on the profit before tax of £5,960 million and in 2017 a tax expense of £1,728 million arose on the profit before tax of £5,625 million. The statutory corporation tax rates were 19.0 per cent for 2018 and 19.25 per cent for 2017.

The tax expense for 2018 represents an effective tax rate of 26.2 per cent compared to 30.7 per cent in 2017. The reduction in effective tax rate compared to 2017 was largely due to higher non-deductible conduct risk provisions in the prior year.

2017 COMPARED WITH 2016

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

The tax expense for 2017 represented an effective tax rate of 30.7 per cent. The high effective tax rate in 2017 was largely due to the banking surcharge, and restrictions on the deductibility of conduct provisions.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LINE OF BUSINESS INFORMATION

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

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

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

The Group's activities are organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

With the exception of PPI, charges in relation to conduct provisions (referred to as remediation) are included in underlying profit. In addition, results in relation to certain assets which are outside the Group's risk appetite, previously reported as part of run-off within Other, have been transferred into Retail and into Commercial. Comparatives have been restated accordingly.

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

– losses on redemption of the Enhanced Capital Notes in 2016 and the volatility in the value of the embedded equity conversion feature;
– restructuring, including severance-related costs, the costs of implementing regulatory reform including ring-fencing, the rationalisation of the non-branch property portfolio, the integration of MBNA and Zurich's UK workplace pensions and savings business;
– market volatility and other items, which includes the effects of certain asset sales, the volatility relating to the Group's own debt and hedging arrangements and that arising in the insurance businesses and insurance gross up, the unwind of acquisition-related fair value adjustments and the amortisation of purchased intangible assets; and
– payment protection insurance provisions.

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

	2018	2017[1]	2016[1]
	£m	£m	£m
Retail	**4,272**	3,770	3,303
Commercial Banking	**2,160**	2,231	2,246
Insurance and Wealth	**927**	899	809
Other	**707**	728	424
Underlying profit before tax	**8,066**	7,628	6,782

1 Segmental analysis restated, as explained above.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Note	**2018 £m**	2017 £m	2016 £m
Underlying profit before tax		**8,066**	7,628	6,782
Enhanced Capital Notes	1	**–**	–	(790)
Market volatility and asset sales	2	**(50)**	279	439
Amortisation of purchased intangibles	3	**(108)**	(91)	(340)
Restructuring costs	4	**(879)**	(621)	(622)
Fair value unwind and other items	5	**(319)**	(270)	(231)
Payment protection insurance provision	6	**(750)**	(1,300)	(1,350)
Statutory profit before tax		**5,960**	5,625	3,888

1. Enhanced Capital Notes

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

2. Market volatility and asset sales

Market volatility and asset sales of £50 million included the loss on sale of the Irish mortgage portfolio of £105 million and an adjustment to the past service pension liability. Also included was negative insurance and policyholder interests volatility totalling £103 million compared to positive volatility of £286 million in 2017 and negative volatility of £91 million in 2016.

Volatility comprises the following:

	2018 £m	2017 £m	2016 £m
Insurance volatility	**(506)**	196	(152)
Policyholder interests volatility	**46**	190	241
Insurance hedging arrangements	**357**	(100)	(180)
Total	**(103)**	286	(91)

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

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

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

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

Management compensates for the limitations above by:

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

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

Insurance volatility

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

The expected gross investment returns used to determine the underlying profit of the business are based on prevailing market rates and published research into historical investment return differentials for the range of assets held. The basis for calculating these expected returns reflects an average of the 15 year swap rate over the preceding 12 months updated throughout the year to reflect changing market conditions. The volatility movements in the period were largely driven by insurance volatility arising from equity market movements and credit spreads. The capital impact of equity market movements is hedged within Insurance and this also reduces the IFRS earnings exposure.

Policyholder interests volatility

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

Accounting standards require that tax on policyholder investment returns relating to life products should be included in the Group's tax charge rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the expected approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are

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adjusted through policyholder interests volatility. In 2018, the statutory results before tax included a credit to other income which relates to policyholder interests volatility totalling £46 million reflecting movements in equity, bond and gilt returns relating to life products.

Insurance hedging arrangements

The Group actively manages its exposures to interest rate, foreign currency exchange rate, inflation and market movements within the banking book through a comprehensive hedging strategy. This helps to mitigate earnings volatility and reduces the impact of market movements on the capital position.

3. Amortisation of purchased intangibles

The Group incurred a charge for the amortisation of intangible assets, principally those recognised on the acquisition of HBOS, of £108 million (2017: £91 million; 2016: £340 million).

4. Restructuring costs

Restructuring costs were £879 million (2017: £621 million; 2016: £622 million) and included severance costs relating to the Group's strategic investment plans as well as the costs of the integration of MBNA and Zurich's UK workplace pensions and savings business, the costs of implementing regulatory reform including ring-fencing and the rationalisation of the non-branch property portfolio. The charge in 2017 and 2016 also included severance costs relating to the Simplification programme.

5. Fair value unwind and other items

The statutory (IFRS) results include the impact of the acquisition-related fair value adjustments, arising from the acquisition of HBOS and MBNA. In 2018 the principal financial effect of the fair value unwind is to reflect the effective interest rates applicable at the date of acquisition, on assets and liabilities that were acquired at values that differed from their original book value.

6. Payment protection insurance provision

The payment protection insurance charge was £750 million (2017: £1,300 million). The charge in 2018 related to a number of factors including higher expected complaint volumes, which increased to 13,000 per week, and associated administration costs, an increase in average redress per complaint, additional operational costs to deal with potential complaint volatility and continued improvements in data interrogation and the Group's ability to identify valid complaints. The outstanding balance sheet provision at 31 December 2018, excluding the provision in MBNA, was £1,329 million and continues to assume around 13,000 complaints per week until the timebar in August 2019.

DIVISIONAL RESULTS

RETAIL

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

	2018 £m	2017[1] £m	2016[1] £m
Net interest income	**9,066**	8,706	8,074
Other income	**2,171**	2,221	2,165
Total income	**11,237**	10,927	10,239
Operating lease depreciation	**(921)**	(947)	(777)
Net income	**10,316**	9,980	9,462
Operating costs	**(4,915)**	(4,866)	(4,761)
Remediation	**(267)**	(633)	(750)
Total costs	**(5,182)**	(5,499)	(5,511)
Impairment	**(862)**	(711)	(648)
Underlying profit	**4,272**	3,770	3,303

1 Restated, as explained on page 24.

2018 COMPARED WITH 2017

Underlying profit increased by £502 million, or 13 per cent, to £4,272 million in 2018 compared to £3,770 million in 2017.

Net interest income increased by £360 million, or 4 per cent, to £9,066 million in 2018 compared to £8,706 million in 2017, reflecting the benefits of a full year of MBNA and lower funding costs more than offsetting ongoing mortgage pricing pressure.

Other income decreased £50 million, or 2 per cent, to £2,171 million in 2018 compared to £2,221 million in 2017, driven by implementation of a simpler overdraft fee structure.

Operating lease depreciation decreased £26 million, or 3 per cent, to £921 million in 2018 compared to £947 million in 2017, reflecting improved used car market prices.

Operating expenses increased by £49 million, or 1 per cent, to £4,915 million in 2018 compared to £4,866 million in 2017 as increased investment in the business is partly offset by efficiency savings.

Remediation costs decreased by £366 million, or 58 per cent to £267 million in 2018 compared to £633 million in 2017, driven by lower provision charges across existing programmes.

Impairment increased by £151 million, or 21 per cent, to £862 million in 2018 compared to £711 million in 2017, largely due to the full year inclusion of MBNA and non-repeat of UK mortgages write-backs.

2017 COMPARED WITH 2016

Underlying profit increased by £467 million, or 14 per cent, to £3,770 million in 2017 compared to £3,303 million in 2016, including MBNA which was acquired on 1 June 2017.

Net interest income increased by £632 million, or 8 per cent, to £8,706 million in 2017 compared to £8,074 million in 2016, reflecting the acquisition of MBNA and driven by deposit repricing offsetting mortgage margin pressures.

Other income increased £56 million, or 3 per cent, to £2,221 million in 2017 compared to £2,165 million in 2016, driven by continued fleet growth in Lex Autolease.

Operating lease depreciation increased £170 million, or 22 per cent, to £947 million in 2017 compared to £777 million in 2016, again driven by continued fleet growth in Lex Autolease and increased conservatism in residual value management.

Operating expenses increased by £105 million, or 2 per cent, to £4,866 million in 2017 compared to £4,761 million in 2016 mainly due to the inclusion of MBNA as well as increased investment spend and pay-related growth, partly offset by underlying efficiency savings.

Remediation costs decreased by £117 million, or 16 per cent, to £633 million in 2017 compared to £750 million in 2016, driven by lower provisions across existing conduct issues.

Impairment increased by £63 million, or 10 per cent, to £711 million in 2017 compared to £648 million in 2016, largely due to the addition of MBNA, partly offset by a lower charge reflecting the resilient economic environment.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMMERCIAL BANKING

Commercial Banking has a client-led, low risk, capital efficient strategy, committed to supporting UK-based clients and international clients with a link to the UK. Through its segmented client coverage model it provides clients with a range of products and services such as lending, transactional banking, working capital management, risk management and debt capital markets services. Continued investment in capabilities and digital propositions enables the delivery of a leading customer experience, supported by increasingly productive relationship managers, with more time spent on value-adding activities.

	2018 £m	2017[1] £m	2016[1] £m
Net interest income	3,004	3,030	2,863
Other income	1,653	1,798	1,875
Total income	4,657	4,828	4,738
Operating lease depreciation	(35)	(105)	(118)
Net income	4,622	4,723	4,620
Operating costs	(2,167)	(2,230)	(2,215)
Remediation	(203)	(173)	(148)
Total costs	(2,370)	(2,403)	(2,363)
Impairment	(92)	(89)	(11)
Underlying profit	2,160	2,231	2,246

1 Restated, as explained on page 24.

2018 COMPARED WITH 2017

Commercial Banking underlying profit decreased by £71 million, or 3 per cent, to £2,160 million in 2018 compared to £2,231 million in 2017 reflecting lower income partially offset by lower expenses.

Net interest income decreased by £26 million, or 1 per cent, to £3,004 million in 2018 compared to £3,030 million in 2017 with the net interest margin lower and partly offset by higher average interest-earning assets.

Other income decreased by £145 million to £1,653 million in 2018 compared to £1,798 million in 2017 reflecting challenging market conditions leading to lower levels of client activity. 2017 included a number of significant one-off refinancing and hedging transactions.

Operating lease depreciation decreased by £70 million to £35 million in 2018 compared to £105 million in 2017 due to lower accelerated charges on a number of legacy and discontinued assets.

Operating expenses decreased by £63 million to £2,167 million in 2018 compared to £2,230 million in 2017 reflecting efficiency savings despite increased investment.

Remediation costs increased by £30 million to £203 million in 2018 compared to £173 million in 2017.

Impairments increased by £3 million, to £92 million in 2018 compared to £89 million in 2017 with the increase driven by expected lower releases and write backs.

2017 COMPARED WITH 2016

Commercial Banking underlying profit decreased by £15 million, to £2,231 million in 2017 compared to £2,246 million in 2016.

Net interest income increased by £167 million, or 6 per cent, to £3,030 million in 2017 compared to £2,863 million in 2016 with an improvement in net interest margin supported by broad based franchise growth.

Other income decreased by £77 million to £1,798 million in 2017 compared to £1,875 million in 2016 as a result of fewer significant transactions in the second half of the year and reduced client activity compared to 2016.

Operating lease depreciation decreased slightly by £13 million to £105 million in 2017 compared to £118 million in 2016.

Operating expenses increased by £15 million to £2,230 million in 2017 compared to £2,215 million in 2016 due to continued investment in the business partially offset by efficiencies.

Remediation costs increased by £25 million to £173 million in 2017 compared to £148 million in 2016.

Impairments increased by £78 million to a charge of £89 million in 2017 reflecting expected lower levels of releases and recoveries, and a large single name charge in 2017.

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INSURANCE AND WEALTH

Insurance and Wealth offers insurance, investment and wealth management products and services. It supports around 10 million customers with assets under administration of £141 billion and annualised annuity payments in retirement of over £1 billion. The Group continues to invest significantly in the development of the business, with the aims of capturing considerable opportunities in pensions and financial planning, offering customers a single home for their banking and insurance needs and driving growth across intermediary and relationship channels through a strong distribution model.

	2018 £m	2017[1] £m	2016[1] £m
Net interest income	123	133	80
Other income	1,865	1,846	1,878
Total income, net of insurance claims	1,988	1,979	1,958
Operating costs	(1,021)	(1,040)	(1,046)
Remediation	(39)	(40)	(103)
Total costs	(1,060)	(1,080)	(1,149)
Impairment	(1)	–	–
Underlying profit	927	899	809

1 Restated, as explained on page 24.

2018 COMPARED WITH 2017

Underlying profit from Insurance and Wealth was £28 million, or 3 per cent, higher at £927 million compared to £899 million in 2017 as a result of an increase of £9 million in total income, net of insurance claims and a £19 million decrease in operating costs.

Net interest income decreased by £10 million, or 8 per cent, to £123 million from £133 million in 2017 due to a higher net interest charge within Insurance primarily reflecting higher LIBOR rates.

Other income increased by £19 million, or 1 per cent to £1,865 million from £1,846 million in 2017. Life and pensions new business income was up 87 per cent to £526 million partly offset by a £26 million decrease in total general insurance income net of claims, including around £60 million impact from higher weather related claims. Lower experience and other items primarily due to the non-recurrence of £170 million income from the addition of death benefits in 2017.

Operating costs were £19 million lower, with cost savings more than offsetting higher investment in the business.

Remediation decreased by £1 million, or 3 per cent, to £39 million from £40 million.

2017 COMPARED WITH 2016

Underlying profit from Insurance and Wealth was £90 million, or 11 per cent higher at £899 million compared to £809 million in 2016 as a result of higher Insurance income and lower remediation costs, partly offset by lower Wealth income. Operating costs remained flat, with higher investment costs offset by lower business as usual costs.

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

Other income decreased by £32 million, or 2 per cent, to £1,846 million from £1,878 million in 2016 reflecting lower margins in Insurance as a result of the competitive environment, strengthening of underlying assumptions and lower bulk annuity sales. General insurance income fell due to the continued competitiveness of the home insurance marketplace.

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

Remediation decreased by £63 million, or 61 per cent, to £40 million from £103 million as no provisions were made in 2017 in respect of customer claims in relation to insurance branch business in Germany.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INCOME BY PRODUCT GROUP

	2018			2017[1]			2016[1]		
	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m
Workplace, planning and retirement	333	153	486	131	125	256	146	122	268
Individual and bulk annuities	160	84	244	125	88	213	207	92	299
Protection	20	22	42	13	20	33	19	17	36
Longstanding life, pensions and investments	13	414	427	12	440	452	9	441	450
	526	673	1,199	281	673	954	381	672	1,053
Life and pensions experience and other items			143			358			141
General Insurance			272			298			354
			1,614			1,610			1,548
Wealth			374			369			410
Total income			1,988			1,979			1,958

1 Restated, as explained on page 24.

2018 COMPARED WITH 2017

New business income has increased by £245 million to £526 million, driven by increases in new members in existing workplace schemes, increased auto enrolment workplace contributions and bulk annuities.

Existing business income is unchanged at £673 million, with positive impact of economics offset by legacy products run-off.

Experience and other items contributed a net benefit of £143 million. This was £215 million lower than 2017 primarily due to £170 million of income from the addition of death benefits in 2017.

2017 COMPARED WITH 2016

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER

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

	2018 £m	2017[1] £m	2016[1] £m
Total income	842	791	504
Operating lease depreciation	–	(1)	–
Net income	842	790	504
Operating costs	(62)	(48)	(71)
Remediation	(91)	(19)	(23)
Total costs	(153)	(67)	(94)
Impairment release	18	5	14
Underlying profit	707	728	424

1 Restated, as explained on page 24.

2018 COMPARED WITH 2017

The underlying profit in Central items was £21 million, or 3 per cent, lower at £707 million in 2018 compared to £728 million in 2017.

Net income was £52 million, or 7 per cent, higher at £842 million in 2018 compared to £790 million in 2017; this includes an increased level of venture capital gains in Lloyds Development Capital and gains on sales of liquid assets, including gilts, of £270 million (2017: £274 million) and 2017 also included the gain on sale of the Group's investment in Vocalink of £146 million.

Total costs were £86 million higher at £153 million in 2018 compared to £67 million in 2017 due mainly to a £72 million increase in remediation charges.

There was an impairment release of £18 million in 2018 compared to £5 million in 2017.

2017 COMPARED WITH 2016

The underlying profit in Central items was £304 million, or 72 per cent, higher at £728 million in 2017 compared to £424 million in 2016.

Total income increased by £287 million, or 57 per cent, from £504 million in 2016 to £791 million in 2017 largely as a result of the gain of £146 million on the sale of the Group's interest in Vocalink and the gains on sales of liquid assets, including gilts, of £ 274 million (2016: £112 million).

Operating costs were £23 million, or 32 per cent, lower at £48 million in 2017 compared to £71 million in 2016.

There was a small impairment release of £5 million in 2017 (2016: £14 million).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2018 Average balance £m	Interest income £m	Yield %	2017 Average balance £m	Interest income £m	Yield %	2016 Average balance £m	Interest income £m	Yield %
Assets									
Financial assets at amortised cost:									
Loans and advances to banks	67,609	565	0.84	67,049	271	0.40	82,409	381	0.46
Loans and advances to customers	476,149	15,078	3.17	464,944	14,712	3.16	457,622	15,190	3.32
Debt securities	4,129	66	1.60	3,332	43	1.29	3,797	56	1.47
Held-to-maturity investments				–	–	–	16,003	231	1.44
Financial assets at fair value through other comprehensive income	32,334	640	1.98						
Available-for-sale financial assets				50,049	980	1.96	40,604	762	1.88
Total interest-earning assets of banking book	580,221	16,349	2.82	585,374	16,006	2.73	600,435	16,620	2.77
Total interest-earning financial assets at fair value through profit or loss	83,887	1,758	2.10	79,754	1,772	2.22	81,961	1,594	1.94
Total interest-earning assets	664,108	18,107	2.73	665,128	17,778	2.67	682,396	18,214	2.67
Allowance for impairment losses on financial assets held at amortised cost	(3,074)			(2,161)			(2,536)		
Non-interest earning assets	157,026			155,853			148,965		
	818,060	18,107	2.21	818,820	17,778	2.17	828,825	18,214	2.20

Total average assets and interest income

	2018			2017			2016		
	Average interest earning assets £m	**Net interest income £m**	**Net interest margin %**	Average interest earning assets £m	Net interest income £m	Net interest margin %	Average interest earning assets £m	Net interest income £m	Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	580,221	13,396	2.31	585,374	10,912	1.86	600,435	9,274	1.54
Trading securities and other financial assets at fair value through profit or loss	83,887	1,191	1.42	79,754	1,294	1.62	81,961	1,060	1.29
	664,108	14,587	2.20	665,128	12,206	1.84	682,396	10,334	1.51

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2018 **Average balance £m**	**Interest expense £m**	**Cost %**	2017 Average balance £m	Interest expense £m	Cost %	2016 Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders' funds									
Deposits by banks	8,405	117	1.39	6,758	80	1.18	10,540	68	0.65
Customer deposits	342,970	1,813	0.53	348,683	1,722	0.49	366,178	2,520	0.69
Liabilities to banks and customers under sale and repurchase agreements	25,634	245	0.96	18,943	110	0.58	8,342	38	0.46
Debt securities in issue[1]	86,099	234	0.27	72,762	266	0.37	85,030	799	0.94
Amounts payable to unitholders in consolidated open-ended investment vehicles	13,915	(844)	(6.07)	15,675	1,435	9.15	18,961	2,057	10.85
Subordinated liabilities	18,193	1,388	7.63	18,674	1,481	7.93	22,330	1,864	8.35
Total interest-bearing liabilities of banking book	495,216	2,953	0.60	481,495	5,094	1.06	511,381	7,346	1.44
Total interest-bearing liabilities of trading book	44,101	567	1.29	55,288	478	0.86	50,700	534	1.05
Total interest-bearing liabilities	539,317	3,520	0.65	536,783	5,572	1.04	562,081	7,880	1.40
Interest-free liabilities									
Non-interest bearing customer accounts	72,913			66,276			54,379		
Other interest-free liabilities	157,072			166,403			163,688		
Non-controlling interests and shareholders' funds	48,758			49,358			48,677		
Total average liabilities and interest expense	818,060	3,520	0.43	818,820	5,572	0.68	828,825	7,880	0.95

1 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.68 per cent (2017: 2.43 per cent; 2016: 2.70 per cent).

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

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

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CHANGES IN NET INTEREST INCOME – VOLUME AND RATE ANALYSIS

The following table allocates changes in net interest income between volume and rate for 2018 compared with 2017 and for 2017 compared with 2016. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2018 compared with 2017 Increase/(decrease)			2017 compared with 2016 Increase/(decrease)		
	Total change £m	Volume £m	Rate £m	Total change £m	Volume £m	Rate £m
Interest receivable and similar income						
At amortised cost:						
Loans and advances to banks	294	5	289	(110)	(61)	(49)
Loans and advances to customers	366	355	11	(478)	231	(709)
Debt securities	23	13	10	(13)	(6)	(7)
Held-to-maturity investments				(231)	(231)	–
Financial assets at fair value through other comprehensive income (2017 and 2016: available-for-sale financial assets)	(340)	(351)	11	218	185	33
Total banking book interest receivable and similar income	343	22	321	(614)	118	(732)
Total interest receivable and similar income on financial assets at fair value through profit or loss	(14)	87	(101)	178	(49)	227
Total interest receivable and similar income	329	109	220	(436)	69	(505)
Interest payable						
Deposits by banks	37	23	14	12	(45)	57
Customer deposits	91	(30)	121	(798)	(86)	(712)
Liabilities to banks and customers under sale and repurchase agreements	135	64	71	72	60	12
Debt securities in issue	(32)	36	(68)	(533)	(45)	(488)
Amounts payable to unitholders in consolidated open-ended investment vehicles	(2,279)	107	(2,386)	(622)	(301)	(321)
Subordinated liabilities	(93)	(37)	(56)	(383)	(290)	(93)
Total banking book interest payable	(2,141)	163	(2,304)	(2,252)	(707)	(1,545)
Total interest payable on trading and other liabilities at fair value through profit or loss	89	(144)	233	(56)	39	(95)
Total interest payable	(2,052)	19	(2,071)	(2,308)	(668)	(1,640)

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RISK OVERVIEW

EFFECTIVE RISK MANAGEMENT AND CONTROL

THE GROUP'S APPROACH TO RISK

As a Group, managing risk effectively is fundamental to the Group's strategy and future success. The Group is a simple, low risk, UK-focused financial services provider with a culture founded on strong risk management and a prudent through the cycle risk appetite. These are at the heart of everything the Group does, and ensure constructive challenge takes place across the business and underpins sustainable growth.

The Group's approach to risk is founded on an effective control framework, which guides how the Group's colleagues work, behave and the decisions they make. As part of this framework, risk appetite – the amount and type of risk that the Group is prepared to seek, accept or tolerate in delivering Group Strategy – is embedded in policies, authorities and limits across the Group.

The Group's prudent risk culture and appetite, along with close collaboration between Risk division and the business, supports decision-making and has enabled the Group to continue to deliver against its strategic priorities in 2018.

RISK AS A STRATEGIC DIFFERENTIATOR

Risks are identified, managed and mitigated using the Group's comprehensive Risk Management Framework, and the Group's well-articulated risk appetite provides a clear framework for decision-making. The principal risks the Group faces, which could significantly impact the delivery of Group strategy, are discussed on pages 37 to 40.

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

Prudent approach to risk

Being low risk is fundamental to the Group's business model and drives its participation choices. Strategy and risk appetite are developed in tandem and together outline the parameters within which the Group operates.

Strong control framework

The Group's Risk Management Framework is the foundation for the The Board is responsible for approving the Group's risk appetite statement at least annually. Group Board-level metrics are cascaded into more detailed business appetite metrics and limits.

Business focus and accountability

Risk management is an integral feature of how the Group measures and manages performance – for individuals, businesses and the Group. In the first line of defence, business units are accountable for managing risk with oversight from a strong and independent second line of defence Risk division.

Effective risk analysis, management and reporting

Regular close monitoring and comprehensive reporting to all levels of management and the Board ensures appetite limits are maintained and subject to stressed analysis at a risk type and portfolio level, as appropriate.

The Group's approach to risk plays a key role in its strategy of becoming the best bank for customers, colleagues and shareholders.

delivery of effective risk control and ensures that the Group risk appetite is continually developed and controlled.

THE GROUP'S RISK MANAGEMENT FRAMEWORK

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

Accountability for ensuring risk is managed consistently within the Risk Management Framework approved by the Board Confirmation of the effectiveness of the Risk Management Framework and underlying risk and control Setting risk appetite and strategy. Approval of the Risk Management Framework and Group-wide risk principles Review risk appetite, frameworks and principles to be recommended to the Board. Be exemplars of risk management Determined by the Board and senior management. Business units formulate their strategy in line with the Group's risk appetite Supporting a consistent approach to Group-wide behaviour and risk decision-making. Consistency is delivered through the policy framework and risk committee structures Monitoring, oversight and assurance ensure effective risk management across the Group Defined processes exist to identify, measure and control the Group's current and emerging risks In line with the Group's code of responsibility. Culture ensures performance, risk and reward are aligned Risk-specific needs defined in detail for implementation by each business Board authorities Through Board-delegated executive authorities there is effective oversight of risk management consistent with risk appetite The risk appetite framework ensures the Group's risks are managed in line with the Group's risk appetite Supports a consistent approach to enterprise-wide behaviour and decision-making Maintains a robust control framework, identifying and escalating emerging risks and supporting sustainable growth Carried out by all three lines of defence and is an integral part of the Group's control effectiveness assessment Processes and infrastructure are being invested in to further improve the Group's risk management capabilities Risk type specific sub-frameworks e.g. credit risk Board role Senior management role Risk appetite Governance framework Three lines of defence Risk and control cycle from identification to reporting Risk culture Risk resources and capabilities Primary risk categories

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2018 THEMES

The Group's priorities for risk management have continued to evolve, alongside progression of the Group's strategy and development of external factors.

The Group's principal risks are outlined over the next few pages but a number of themes have been particularly prevalent in 2018.

EU exit

Given the vast majority of its business is in the UK, the direct impact on its from leaving the EU is relatively small and the Group is well prepared to ensure continuity of its limited EU business activities.

Given the Group's UK focus, its performance is inextricably linked to the health of the UK economy. Economic performance has remained resilient in recent years and whilst the near-term outlook for the UK economy remains minimise the impact on its customers. The Group has also been working hard to ensure it is well prepared to provide customers with effective and timely support.

Data

The Group is trusted with large volumes of data, which must be protected, whilst providing customers with ease of access through the Group's multi-channel model. Data is the Group's most valuable asset and so the Group must ensure that the information it holds is accurate, secure and managed appropriately. The Group meets the requirements of the General Data Protection Regulation (GDPR) that came into force in May 2018. The Group has taken this opportunity to implement new governance structures and demonstrate increased levels of accountability and transparency, as establishing trust is critical to the Group's vision of being the best bank for customers. The Group has created a Group Data Protection Office (GDPO) to independently oversee compliance, reporting on this to Group and Board Risk Committees.

The Group drives a culture of compliance through its Data Privacy policy and control framework and has implemented robust governance to oversee compliance with GDPR, as well as enhanced staff training. During 2019 the Group will continue to drive enhancements to the maturity of its data control environment.

Cyber

Cyber threats are increasingly complex and like all financial services providers, attempts are made on a regular basis to attack the Group's systems and services, and to steal customer and bank data. Given the significant threat the Group continues to strengthen the resilience of its IT systems and invest in its cyber control framework.

The Group is simplifying and modernising its IT architecture, alongside deploying technologies such as cloud computing which offer greater levels of resilience, capacity management and speed of processing. The Group is a member of the UK's Cyber Defence Alliance, where a number of UK-based banks and law enforcement agencies collaborate in the fight against cyber-attacks, sharing expertise, intelligence and knowledge. Within Lloyds Banking Group, the Chief Security Office engenders a culture whereby colleagues are considered to be the Group's first line of defence. Vigilance and training are key to preventing cyber-attacks.

Sustainability

The Group has been developing its sustainability strategy, to address more broadly the opportunities and threats related to climate change, and the need for the UK to transition to a sustainable, lower carbon economy. This is in line with the Group's commitment to implement the Task Force for Climate-related Financial Disclosures' recommendations. For risk management, addressing the potential impacts of climate change plays a key role in the Group's approach to sustainability, and this year the Group has identified climate change as a top emerging risk.

unclear given the ongoing EU withdrawal negotiations, the Group has contingency plans in place.

The Group has also taken a prudent approach to its balance sheet, increasing the amount of liquidity held and pre-funding some issuance.

Irrespective of the outcome, the Group's customer focused strategy remains the right one. The Group will continue to support its personal and business customers and has already announced that it will lend up to £18 billion to UK businesses in 2019, reaffirming the Group's support for the UK economy.

Guided by the overriding principle of Helping Britain Prosper, the Group will seek to

RISK MANAGEMENT – ENHANCING THE CUSTOMER EXPERIENCE

The Group recognises that the primary role of risk management is to protect the Group's customers, colleagues and the Group, whilst enabling sustainable growth. Risk management is able to fulfil this purpose whilst also supporting the Group's strategic priorities and delivering better outcomes for customers. Here are some of the ways Risk Division has contributed to the Group's strategic priorities and enhancing the customer experience this year.

Credit risk

LEADING CUSTOMER EXPERIENCE

The Group is committed to adapting to changing customer expectations. With increasing competition and digital propositions in the market, customers expect great service and a frictionless experience.

This year Risk division increased the use of automated property valuations for the mortgage application process through Halifax, reducing the time it takes for the Group to offer customers a mortgage to buy a property by an average of one week. By speeding up this part of the process and removing an extra step, customers have more time to focus on what matters most during life-changing events such as buying a home.

MAXIMISING THE GROUP'S CAPABILITIES

The Group remains committed to supporting its customers and their businesses across the country.

Within Commercial Banking, teams look specifically at how industry risks impact success, and tailor advice and lending based on the dynamics of a segment or sector. One such example is in the Group's SME dairy sector which has experienced significant pressures due to falling milk prices. The Group's relationship managers and risk teams have been working together to understand each client's farm and its changing needs so the Group can provide the best support possible. This may be through extending working capital or restructuring facilities, in order to drive better outcomes for the businesses the Group serves.

Operational risk

DIGITISING THE GROUP

Deploying new technology to make banking simpler and safer for customers is a key priority for the Group.

The Group has already implemented a number of significant enhancements across various products and services. For example, from a risk perspective the Group has changed how it authenticates suspicious transactions across personal debit and credit cards. Rather than decline the payment and request that the customer contact the Group, the Group sends a text with a unique code which enables the customer to quickly and easily verify that the transaction is genuine. This has helped to protect the Group's customers and made the experience simpler by communicating in a method convenient to them.

TRANSFORMING WAYS OF WORKING

The Group's nationwide Fraud analytics and insight team looks after the systems which detect fraud for the Group.

The team has embraced agile working due to the nature of its role: at short notice they might be called upon to respond to a new fraud attack, which can require working long hours or into the night. The team also supports a large number of the Group's change programmes, often working outside regular hours. To meet the needs of the colleague, the team and the Group, working patterns are agreed on an individual basis.

There has been a strong reduction in fraud losses over the last five years; while some of this is due to investment in systems, the Group places great reliance on having well trained, engaged and motivated teams.

THE GROUP'S PRINCIPAL RISKS

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

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

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

Principal risks and uncertainties are reviewed and reported regularly. As part of a review of the Group's risk categories, the secondary risk categories of Change, Data management and Operational resilience have been elevated to primary risk categories, and Strategic risk has been included as a new primary risk category, in the Group's Risk Management Framework. These changes will be embedded during 2019 and reflected within the Group's principal risks.

CREDIT

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

Example

Observed or anticipated changes in the economic environment could impact profitability due to an increase in delinquency, defaults, write-downs and/or expected credit losses

Key mitigating actions

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

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

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

During the year the Group strengthened affordability buffers and improved controls to restrict lending to consumers with higher risk of over-indebtedness

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

Early identification of signs of stress leading to prompt engagement with the customer

Key risk indicators

£937m	**£5,741m**
Impairment charge	Stage 3 assets
2017: £795m	1 Jan 2018: £5,140m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

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

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

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

REGULATORY AND LEGAL

The risk that the Group is exposed to financial loss, fines, censure, or legal or enforcement action; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including codes of practice which could have legal implications), regulations, codes of conduct or legal obligations, or a failure to adequately manage actual or threatened litigation, including criminal proceedings.

Example

Failure to deliver key regulatory changes or to comply with ongoing requirements

Key mitigating actions

Implementation of compliance and legal risk management policies and procedures to ensure appropriate controls and processes are in place to comply with legislation, rules and regulation

Embedding Group-wide processes to monitor ongoing compliance with new legislation, rules and regulation

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

Ongoing engagement with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations, ensuring programmes are established to deliver new regulation and legislation

Ongoing horizon scanning to identify changes in regulatory and legal requirements

Key risk indicators

£993m

Mandatory, legal and regulatory investment spend 2017: £886m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

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

CONDUCT

The risk of customer detriment due to poor design, distribution and execution of products and services or other activities which could undermine the integrity of the market or distort competition leading to unfair customer outcomes, regulatory censure and financial and reputational loss.

Example

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

Key mitigating actions

Conduct policies and procedures are in place to ensure appropriate controls and processes that deliver fair customer outcomes

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

Product approval, continuous product review processes and customer outcome testing in place (across products and services)

Learning from past mistakes through root cause analysis

Clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics

Further enhancements and embedding of the Group's framework to support all customers, including those in vulnerable circumstances

Key risk indicators

92.5%

Conduct risk appetite metric performance-Group 2017: 92.3%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

The Group has senior committees that ensure the Group's focus on embedding a customer-centric culture and delivering fair outcomes across the Group. Further enhancements to the Group's conduct risk framework continue to support this through robust and effective management of conduct risk. Together these support the Group's vision of being the best bank for customers, enabling the delivery of a leading customer experience through effective root cause analysis and learning from customer feedback.

OPERATIONAL

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

Example

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

Key mitigating actions

Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems, and to ensure effective third-party assurance

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

Significant investment in compliance with General Data Protection Regulation and Basel Committee on Banking Supervision standards

Working with industry bodies and law enforcement agencies to identify and combat fraud and money laundering

Key risk indicators

99.97%

Availability of core systems
2017: 99.98%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

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

PEOPLE

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

Example

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

Key mitigating actions

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

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

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

During 2018 the Group enhanced its colleague wellbeing strategies to ensure support is in place to meet colleague needs, and to help achieve the skills and capability growth required to build a workforce for the 'Bank of the Future'

Key risk indicators

79%

Values and behaviours index[1]
2017: 80%

Alignment to strategic priorities and future focus

Transforming ways of working

Regulatory requirements relating to personal accountability and remuneration rules could affect the Group's ability to attract and retain the calibre of colleagues required to meet changing customer needs. The Group recognises the challenges in delivering its strategic priorities and will continue to invest in the development of colleague capabilities and agile working practices. This investment will deliver a leading customer experience and allow the Group to respond quickly to customers' rapidly changing decision-making in a digital era.

1 Formerly known as Best bank for customers index.

INSURANCE UNDERWRITING

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

Example

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

Key mitigating actions

Strategic decisions made consider the maintenance of the current well-diversified portfolio of insurance risks

Processes for underwriting, claims management, pricing and product design seek to control exposure. Experts in demographic risk (for example longevity) support the propositions

Reinsurance and other risk transfer arrangements are actively reviewed for their efficacy, including monitoring the strength of third-parties with whom the risk is shared

Key risk indicators

£14,384m Insurance (Life and Pensions present value of new business premiums) 2017: £9,951m	**£690m** General Insurance underwritten total gross written premiums 2017: £733m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

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

CAPITAL

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

Example

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

Key mitigating actions

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

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

Comprehensive stress testing analyses to evidence capital adequacy

Key risk indicators

13.9% Common equity tier 1 ratio[1,2] 2017: 13.9%	**5.6%** UK leverage ratio[1] 2017: 5.4%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

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

1 Adjusted.

2 CET1 ratio after ordinary dividends and share buyback.

FUNDING AND LIQUIDITY

Funding risk is the risk that the Group does not have sufficiently stable and diverse sources of funding. Liquidity risk is the risk that the Group has insufficient financial resources to meet its commitments as they fall due.

Example

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

Key mitigating actions

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

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

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

Key risk indicators

£129bn	**107%**
LCR eligible assets	Loan to deposit ratio
2017: £121bn	1 Jan 2018: 107%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GOVERNANCE

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from ensuring that the Group continues to demonstrate compliance with the requirements to ring-fence core UK financial services and activities, the potential impact of EU exit and further requirements under the Senior Manager & Certification Regime (SM&CR).

Examples

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

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

Key mitigating actions

To meet ring-fencing requirements, core UK financial services and activities have been ring-fenced from other activities of the Group and an appropriate control environment and governance structures are in place to ensure compliance

A dedicated change programme is in place and addressing the additional SM&CR requirements which will come into force during 2019

A dedicated programme is in place to assess and address the potential impacts of EU exit on the Group's operations in Europe. The Group is in close and regular contact with regulators to develop and deploy its planned operating and legal structure to mitigate the potential impacts of EU exit

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

Key risk indicators

N/A

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

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

MARKET

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

Examples

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

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

Narrowing credit spreads will increase the cost of pension scheme benefits

Key mitigating actions

Structural hedge programmes implemented to manage liability margins and margin compression

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

The Group's defined benefit pension schemes continue to monitor their credit allocation as well as the hedges in place against nominal rate and inflation movements

Key risk indicators

£1,146m

IAS 19 Pension surplus
2017: £509m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group actively manages its exposure to movements in market rates, to drive lower volatility earnings and offer a comprehensive customer proposition with hedging strategies to support strategic aims. Mitigating actions are implemented to reduce the impact of market movements, resulting in a more stable capital position. Effective interest rate and inflation hedging has kept volatility in the Group's defined benefit pension schemes low. This combined with improved market conditions has helped keep the schemes in IAS 19 surplus in 2018. This allows the Group to more efficiently utilise available capital resources to better enable the Group to maximise its capabilities.

MODEL

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

Example

The consequences of inadequate models could include: inappropriate levels of capital or impairments; inappropriate credit or pricing decisions; and adverse impacts on funding or liquidity, or the Group's earnings and profits

Key mitigating actions

A comprehensive model risk management framework

Defined roles and responsibilities, with clear ownership and accountability

Principles regarding the requirements of data integrity, development, validation, implementation and ongoing maintenance

Regular model monitoring

Independent review of models

Periodic validation and re-approval of models

Key risk indicators

N/A

Alignment to strategic priorities and future focus

Digitising the Group

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

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RISK MANAGEMENT

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

The Group's mission is to protect its customers, colleagues and the Group, whilst enabling sustainable growth in targeted segments. This is achieved through informed risk decision-making and superior risk and capital management, supported by a consistent risk-focused culture.

The risk overview (pages 35 to 40) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, key areas of focus for risk during 2018, and the role of risk management in enhancing the customer experience, along with an overview of the Group's Risk Management Framework, and the principal risks faced by the Group and key mitigating actions.

This full risk management section provides a more in-depth picture of how risk is managed within the Group, detailing the Group's emerging risks, approach to stress testing, risk governance, committee structure, appetite for risk (pages 41 to 50) and a full analysis of the primary risk categories (pages 50 to 103) – the framework by which risks are identified, managed, mitigated and monitored.

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

THE GROUP'S APPROACH TO RISK

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

To meet ring-fencing requirements from 1 January 2019, core UK retail financial services and ancillary retail activities have been ring-fenced from other activities of the Group. The Group Risk Management Framework and Group Risk Appetite apply across the Group and are supplemented by risk management frameworks and risk appetites for the sub-groups to meet sub-group specific needs. In each case these are aligned to the Group position. The Group's Corporate Governance Framework applies across Lloyds Banking Group plc, Lloyds Bank plc, Bank of Scotland plc and HBOS plc. It is tailored where needed to meet the entity specific needs of Lloyds Bank plc and Bank of Scotland plc, and supplementary Corporate Governance Frameworks are in place to address sub-group specific requirements of the other sub-groups (LBCM, Insurance and LBG Equity Investments). See revised Group governance arrangements and Group restructure to comply with ring-fencing on page 135.

RISK CULTURE

Based on the Group's conservative business model, prudent approach to risk management, and guided by the Board, the senior management articulates the core risk values to which the Group aspires, and sets the tone at the top, with a strong focus on building and sustaining long-term relationships with customers through the economic cycle. The Group's code of responsibility reinforces colleague accountability for the risks they take and their responsibility to prioritise their customers' needs.

RISK APPETITE

The Group's risk appetite is defined as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate' in delivering the Group's strategy.

Group strategy and risk appetite are developed in tandem. Business planning aims to optimise value within risk appetite parameters and deliver on the Group's promise to Help Britain Prosper.

The Group's risk appetite statement details the risk parameters within which the Group operates. The statement forms part of the Group's control framework and is embedded into its policies, authorities and limits, to guide decision-making and risk management. The Board is responsible for approving the Group's risk appetite statement at least annually. Group Board-level metrics are cascaded into more detailed business appetite metrics and limits.

Group risk appetite includes the following areas:

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

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

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

Operational – the Group has robust controls in place to manage operational losses, reputational events and regulatory breaches. It identifies and assesses emerging risks and acts to mitigate these.

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

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

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

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

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

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

GOVERNANCE AND CONTROL

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

FINANCIAL REPORTING RISK MANAGEMENT SYSTEMS AND INTERNAL CONTROLS

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

- ensure that accounting policies are appropriately and consistently applied, transactions are recorded accurately, and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly stated;
- enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements;
- enable annual certifications relating to maintenance of appropriate tax accounting by the Senior Accounting Officer in accordance with the 2009 Finance Act;
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements (for example UK Finance Code for Financial Reporting Disclosure; US Sarbanes Oxley Act) and, as far as possible, consistent with best practice;
- ensure ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting; and
- ensure an accurate view of the Group's performance to allow the Board and senior management to appropriately manage the affairs and strategy of the business as a whole and each of its sub-groups.

The Group has a Disclosure Committee which assists the Group Chief Executive and Chief Financial Officer in fulfilling their disclosure responsibilities under relevant listing and other regulatory and legal requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see pages 147 to 150.

RISK DECISION-MAKING AND REPORTING

Risk analysis and reporting enables better understanding of risks and returns, supporting the identification of opportunities as well as better management of risks.

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

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

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

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

The table below provides a high level guide to how the Group's business activities are reflected through its risk-weighted assets. Details of the business activities for each division are provided in the Divisional Results on pages 24 to 31.

	Retail £bn	Commercial Banking £bn	Insurance and **Wealth**[1] £bn	Central **items**[2] £bn	Group £bn
Risk-weighted assets (RWAs)					
– Credit risk	74.5	74.7	0.6	11.7	161.5
– Counterparty credit risk[3]	–	4.7	–	2.5	7.2
– Market risk	–	2.0	–	0.1	2.1
– Operational risk	19.8	4.6	0.6	0.5	25.5

Total (excluding threshold)	94.3	86.0	1.2	14.8	196.3
– Threshold[4]	–	–	–	10.1	10.1
Total	94.3	86.0	1.2	24.9	206.4

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

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

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

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

PRINCIPAL RISKS

The Group's principal risks are shown in the risk overview (pages 37 to 40). The Group's emerging risks are shown overleaf. Full analysis of the Group's risk categories is on pages 50 to 103.

EMERGING RISKS

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

Risk	**Key mitigating actions**
Regulatory and legal: The financial sector continues to witness an increased pace, volume and complexity of oversight and regulation from various bodies including government and regulators. Increasing regulatory rules and laws from both the UK and overseas may affect the Group's operation, placing pressure on expert resource and investment priorities. There continues to be uncertainty as to the impact of EU exit or the impact of a no deal outcome on the regulatory and legal landscape. One impact of EU exit will be that the UK loses its ability to make use of the EU Passport for provision of banking services into the EU.	– The Group works closely with regulatory authorities and industry bodies to ensure that the Group can identify and respond to the evolving regulatory and legal landscape. – The Group actively implements programmes to deliver legal, regulatory and mandatory change requirements. – The Group has implemented a programme to assess the legal impacts and risks of an EU exit (including a no deal outcome) and to identify appropriate mitigants, such as establishing EU entities to ensure continuity of certain business activities.
Cyber: Increases in the volume and sophistication of cyber-attacks alongside the growth in connected devices continues to heighten the potential for cyber-enabled crime. Increases in geopolitical tensions increase the indirect threat of a sophisticated attack on the Group. The capability of organised crime groups is growing rapidly, which along with the commoditisation of cyber- crime increases the likelihood that the Group or one of its suppliers will be the direct target of a sophisticated attack. This increases the risk of the Group's exposure through the supply chain.	– Continued investment and priority focus on the Group's Cyber Programme to ensure confidentiality and integrity of data and availability of systems. Key areas of focus relate to access controls, network security, disruptive technology, and denial of service capability. – Embedding of Group Cyber control framework aligned to industry recognised cyber security framework (NIST: National Institute of Standards and Technology). – Three year cyber strategy to deliver an industry-leading approach across the Group and to embed innovation in the Group's approach to cyber. – Increased business and colleague engagement through education and awareness, phishing testing and security culture initiatives. Cyber

risk is governed through all key risk committees and there are quarterly reviews of all cyber risks.

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

– Engagement with politicians, officials, media, trade and other bodies to reassure the Group's commitment to Helping Britain Prosper.

Specifically for the potential impacts of EU exit:

Political uncertainties including EU exit: The continued lack of clarity over the UK's eventual relationship with the EU allied to ongoing challenges in the Eurozone, including protests in France and changes in government in Italy, raise additional uncertainty for the UK economic outlook. Growing public concern over perceived income inequality has also led to a rise in political populism. There also remains the possibility of a further referendum on Scottish independence.

There is a risk of a no deal EU exit outcome or a delay to EU exit, which could result in continuing business uncertainty across the whole UK banking sector.

– Executive forum considering and tracking developments and activity.

– Committed investments to establish new Group entities in the EU to ensure continuity of certain business activities, and contingency planning in relation to wider areas of impact.

– Group Corporate Treasury tracking market conditions closely and actively managing the Group's balance sheet.

– Credit applications and sector reviews include assessment of EU exit risk. Initiatives to help clients effectively identify and manage associated risks.

– Review of the Group's top EU suppliers to identify any impact on service provision and drive appropriate mitigating action.

– No deal EU exit outcome analysed to identify impacts and assess robustness of the Group's contingency plans.

Competition: Adoption of technological trends is accelerating with customer preferences increasingly shaped by tech giants and other challengers who are able to exploit their own infrastructure and are impacted by different market dynamics. Regulation is focusing on lowering barriers for new entrants, which could have an adverse impact on the Group's market position.

Operational complexity has the potential to restrict the Group's speed of response to market trends. Inability to leverage data and innovate could lead to loss of market share as challengers capitalise on Open Banking. Timely delivery of GSR3 objectives remains key to

– The Group is transforming the business to improve customer experience by digitising customer journeys and leveraging branches for complex needs, in response to customers' evolving needs and expectations.

– The Group will deepen insight into customer segments, their perception of brands and what they value.

– Agility will be increased by consolidating platforms and building new architecture aligned with customer journeys.

addressing the competitive challenges facing the Group.

– The Group is responsive to changing customer behaviour/business models and adjusts its risk management approach as appropriate

– GSR3 is designed to support the Group to strengthen its competitive position.

Data: Advancements in new technologies and new services, an increasing external threat landscape, and changing regulatory requirements increase the need for the Group to effectively govern, manage, and protect its data (or the data shared with third-party suppliers). Failure to manage data risk will impact the accuracy, access to and availability of data, ultimately leading to poor customer outcomes, loss of value to the bank and reputational damage.

– The Group's strategy is to introduce advanced data management practices, based on Group-wide standards, data-first culture and modern enterprise data platforms, supported by a simplified modern IT architecture.

– The Group has implemented Open Banking and actively monitors implications for its customers, including protection from fraud.

– We are making a significant investment to improve data privacy, including the security of data and oversight of third-parties.

Macroeconomic headwinds: The UK economic outlook is uncertain. Business investment is lower than historical averages with early signs of pressure in Retail and high street sectors. High levels of credit market liquidity have reduced spreads and weakened terms in some sectors, creating a potential under-pricing of risk and heightened risk of a market correction. These factors could lead to downward pressure on credit quality.

– Wide array of risks considered in setting strategic plans.

– Capital and liquidity are reviewed regularly through committees, ensuring compliance with risk appetite and regulatory requirements.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk	**Key mitigating actions**
Uncertainty remains over UK monetary policy, and tightening US monetary policy is pressuring some emerging markets with potential spill over effects on growth and asset prices in other markets.	– The Group has a robust through the cycle credit risk appetite, including appropriate product, sector and single name concentration parameters, robust sector appetite statements and policies, as well as affordability and indebtedness controls at origination. In addition to ongoing focused monitoring, the Group conducts portfolio deep dives and quarterly larger exposure reviews. The Group has enhanced its use of early warning indicators including sector specific indicators.
Policy tightening in the US and China has weakened global growth prospects; this is likely to bring a pause to US policy normalisation and Chinese deleveraging of its high debt levels, in turn weakening crisis management tools.	– The Group is well positioned against an uncertain economic outlook and is able to withstand potential market volatility and/or downturn due to its selective and pre-emptive credit tightening, robust affordability controls and close monitoring of internal and external trends. – Risk appetite criteria limits single counterparty bank and non-bank exposures complemented by a UK-focused strategy.
Geopolitical shocks: Current uncertainties could further impede the global economic recovery. Global events, as well as terrorist activity including cyber-attacks, have the potential to trigger changes in the economic outlook, market risk pricing and funding conditions.	– The Chief Security Office develops and maintains an Emerald Response Process to respond to external crisis events. This is a rapid reaction group, incorporating Financial Stability Response where appropriate. – The Chief Security Office also maintains the operational resilience framework to embed resilience activities across the Group and limit the impact of internal or external events. – Hedging of market risk considers, inter alia, potential shocks as a result of geopolitical events.
Financial services transformation impact on customers: The risk that transformation of the financial services industry and the Group does not adequately consider vulnerable customers. As technology and innovation move at increasing pace, the more vulnerable could be at a disadvantage.	– Group vulnerability strategy and associated actions being developed throughout the transformation programme. – Digital principles are being agreed across the Group, primarily aimed at preventing material conduct residual risk and giving customers an optimal, informative and fair buying journey to mitigate the increased risks.
The increase in execution only propositions due to digitisation may lead to increased conduct risk where customers (including vulnerable customers) choose unsuitable products. The Group's approach to customer segmentation will need to ensure conduct and reputational risks are well managed.	– Technology risks, including those related to machine learning, are escalated and discussed through governance to ensure ongoing monitoring of any emerging unintended consequences.

Further, there is an emerging risk of unintended consequences within decision-making undertaken by machine learning which could occur on a large scale in a short period of time, creating new operational risks that affect financial and non-financial outcomes, for example credit portfolio anomalies or conduct impacts. This is relevant for the Group at present as the delivery of GSR3 utilises new technologies.	– Emerging customer risks, including those pertaining to vulnerable customers, are managed through customer segmentation strategy governance throughout the change lifecycle.
Climate change: The key risks associated with climate change are physical risks arising from climate and weather-related events, and transition risks, which are the financial risks resulting from the process of adjustment towards a lower carbon economy. Both of these risks may cause the impairment of asset values and impact the creditworthiness of the Group's clients, which could result in currently profitable business deteriorating over the term of agreed facilities. Conversely propositions currently outside of appetite may constitute an acceptable opportunity in the future.	– The Group has embedded Sustainability in its Helping Britain Prosper Plan and Group Property Objectives. – The Group is taking a strategic approach to align with the UK Government's Clean Growth Strategy and have committed to adopting the approach set out by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). – The Group is identifying new opportunities to support customers and clients and to finance the UK's transition to a lower carbon economy.
There is increased focus on these risks by key stakeholders including businesses, clients and investors, and the regulatory landscape is evolving to reflect these risks.	– The Group will embed sustainability into the way it does business and manage its own operations in a more sustainable way, identifying and managing material sustainability-related risks across the Group, and disclosing these in line with the TCFD recommendations.
There is also a risk that campaign groups or other bodies could seek to take legal action (including indirect action) against the Group and/or the financial services industry for investing in or lending to organisations that they deem to be responsible for, or contributing to, climate change.	– The Group will ensure that appropriate training is provided to Relationship managers and Risk colleagues to enable them to have effective sustainability conversations with their clients.
Transition from IBORs to Alternative Risk Free Reference Rates: Widely used benchmark rates, such as the London Interbank Offered Rate ('LIBOR'), have been subject to increasing regulatory scrutiny, with regulators signalling the need to use alternative benchmark rates. As a result, existing benchmark rates may be discontinued or the basis on which they are calculated may change.	– The Group is working closely with the Bank of England initiated Working Group on Sterling Risk-Free Reference Rates on the transition away from LIBOR in the UK. – Maintain close engagement with the FCA on potential impacts. – Working closely with industry bodies to understand and manage the impact of benchmark transition in other geographies.
There is uncertainty across the whole UK Banking sector as to the impact such discontinuation or changes may have and they may adversely affect a broad array of financial products, including any LIBOR-based securities, loans and derivatives.	– Transition project established and the appointment of an IBOR Transition Director as accountable executive.

Any discontinuation or changes could have important implications for both the Group and its customers, for example: necessitating amendments to existing documents and contracts; changes to systems and infrastructures; and the possibility of disputes.

– Working with the Group's customers to ensure they understand the risks or outcomes they might face from transition.

– Establish a clear client communication strategy for all new IBOR linked products. Consider appropriate client communications for legacy contracts as the market end-state position evolves.

– Implement an internal communication strategy and ensure that all relevant staff are aware and have the tools and training required.

CAPITAL STRESS TESTING

Overview

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

Scenario stress testing is used for: Risk Identification:

– Understand key vulnerabilities of the Group and its key legal entities under adverse economic conditions.

Risk Appetite:

– Assess the results of the stress test against the risk appetite of all parts of the Group to ensure the Group and its legal entities are managed within their risk parameters.

– Inform the setting of risk appetite by assessing the underlying risks under stress conditions.

Strategic and Capital Planning:

– Allow senior management and the Boards of the Group and its applicable legal entities to adjust strategies if the plan does not meet risk appetite in a stressed scenario.

– Support the Internal Capital Adequacy Assessment Process (ICAAP) by demonstrating capital adequacy, and meet the requirements of regulatory stress tests that are used to inform the setting of the Prudential Regulation Authority (PRA) and management buffers (see capital risk on pages 79 to 88) of the Group and its separately regulated legal entities.

Risk Mitigation:

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

Regulatory stress tests

In 2018 the Group participated in both the concurrent UK stress test run by the Bank of England (BoE) and in the European Banking Authority's (EBA) bi-annual EU-wide stress test. The EBA stress test did not contain a pass/fail threshold and as announced in November, the Group demonstrated its ability to meet applicable capital requirements under stress conditions. In the case of the BoE stress test, despite the severity of the scenario, the Group exceeded the capital and leverage hurdles after the application of management actions and as a consequence was not required to take any capital actions.

Internal stress tests

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

Reverse stress testing

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

Other stress testing activity

The Group's stress testing programme also involves undertaking assessments of liquidity scenarios, market risk sensitivities and scenarios, and business specific scenarios (see the primary risk categories on pages 50 to 103 for further information on risk-specific stress testing). If required, ad hoc stress testing exercises are also undertaken to assess emerging risks, as well as in response to regulatory requests. This wide ranging programme provides a comprehensive view of the potential impacts arising from the risks to which the Group is exposed and reflects the nature, scale and complexity of the Group.

Methodology

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

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

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Governance

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

The Group Financial Risk Committee (GFRC), chaired by the Chief Risk Officer and attended by the Chief Financial Officer and other senior Risk and Finance colleagues, is the committee that has primary responsibility for overseeing the development and execution of the Group's stress tests. Lloyds Bank Corporate Markets (LBCM) Risk Committee performs a similar function within the scope of LBCM.

The review and challenge of the Group's detailed stress forecasts, the key assumptions behind these, and the methodology used to translate the economic assumptions into stressed outputs conclude with the divisional Finance Directors', appropriate Risk Directors' and Managing Directors' sign-off. The outputs are then presented to GFRC and Board Risk Committee for review and challenge, before being approved by the Board. There is a similar process within LBCM for the governance of the LBCM-specific results.

HOW RISK IS MANAGED IN LLOYDS BANKING GROUP

The Group's Risk Management Framework (RMF) (see risk overview, page 35) is structured around the following components which meet and align with the industry-accepted internal control framework standards.

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

Role of the Board and senior management

Key responsibilities of the Board and senior management include:

– setting risk appetite and approval of the RMF;

– approval of Group-wide risk principles and policies;

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

– effective oversight of risk management consistent with risk appetite.

Risk appetite

Risk appetite is defined within the Group as ‘the amount and type of risk that the Group is prepared to seek, accept or tolerate’ in delivering its Group Strategy (see the Group’s approach to risk page 41).

Governance frameworks

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

Robust processes and controls to identify and report policy breaches are in place. These include clear materiality criteria and escalation procedures which ensure an appropriate level of visibility and prioritisation of remedial actions.

The risk committee governance framework is outlined on page 48.

Three lines of defence model

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

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

Risk division (second line) is a centralised function, headed by the Chief Risk Officer, providing oversight and independent constructive challenge to the effectiveness of risk decisions taken by business management, providing proactive advice and guidance, reviewing, challenging and reporting on the risk profile of the Group and ensuring that mitigating actions are appropriate.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

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

The Risk Directors reporting to the Chief Risk Officer:

- provide independent advice, oversight and challenge to the business;
- design, develop and maintain policies, specific functional risk type frameworks and guidance to ensure alignment with business imperatives and regulatory requirements;
- establish and maintain appropriate governance structures, culture, oversight and monitoring arrangements which ensure robust and efficient compliance with relevant risk type risk appetites and policies;
-

lead regulatory liaison on behalf of the Group including horizon scanning and regulatory development for their risk type; and

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

The primary role of Group Internal Audit (third line) is to help the Board and executive management protect the assets, reputation and sustainability of the Group. Group Internal Audit is led by the Group Chief Internal Auditor. Group Internal Audit provides independent assurance to the Audit Committee and the Board through performing reviews and engaging with committees/executive management, providing opinion and challenge on risk and the state of the control environment. Group Internal Audit is a single independent internal audit function, reporting to the Board Audit Committee of the Group and the Board Audit Committee of the key subsidiaries.

Risk and control cycle from identification to reporting

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

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

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

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

Risk culture

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

Risk resources and capabilities

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

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

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RISK GOVERNANCE

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

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

Table 1.2: **Risk governance structure**

Third line of defence – assurance Group Internal Audit Second Reporting Aggregation, escalation Independent challenge Independent challenge Reporting Audit Committee Board Board Risk Committee Group Chief Executive Group Chief Executive Committees Primary escalation Business area principal Enterprise Risk Committees First line of defence – risk management Independent challenge of both first and second lines of defence Reporting Aggregation, escalation Independent challenge Independent challenge Reporting Risk Division Committees and Governance Second line of defence – risk oversight

Group Chief Executive Committees

Group Executive Committee (GEC)

Group Risk Committee (GRC)

Group Asset and Liability Committee (GALCO)

Group Customer First Committee

Group Cost Management Committee

Conduct Review Committee

Group People Committee

Sustainability Committee

Senior Independent Performance

Adjustment and Conduct Committee

Group Strategic Review 3 Committee

Business area principal Enterprise Risk Committees

Commercial Banking Risk Committee

Retail Risk Committee

Insurance and Wealth Risk Committee

Community Banking Risk Committee

Group Transformation Risk Committees

Finance Risk Committee

People and Productivity Risk Committee

Group Corporate Affairs Risk Committee

Risk Division Committees and Governance

Credit risk

- Executive Credit Approval Committees
- Commercial Banking Credit Risk Committees
- Retail Credit Risk Committees

Market risk

- Group Market Risk Committee

Conduct, compliance and operational risk

- Group Conduct, Compliance and Operational Risk Committee

Fraud and financial crime risk

- Group Fraud and Financial Crime Prevention Committee

Financial risk

- Group Financial Risk Committee

Capital risk

- Group Capital Risk Committee

Model risk

Group Model Governance Committee

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

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BOARD, EXECUTIVE AND RISK COMMITTEES

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

Assisted by the Board Risk and Audit Committees, the Board approves the Group's overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 133 to 155, for further information on Board committees.

The Group's Corporate Governance Framework applies across Lloyds Banking Group plc, Lloyds Bank plc, Bank of Scotland plc and HBOS plc. It is tailored where needed to meet the entity specific needs of Lloyds Bank plc and Bank of Scotland plc, and supplementary Corporate Governance Frameworks are in place to address sub-group specific requirements of the other sub-groups (LBCM, Insurance and LBG Equity Investments).

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

Table 1.3: **Executive and Risk Committees**

In relation to the operation of Lloyds Banking Group plc, the Group Chief Executive is supported by the following:

Committees	**Risk focus**
Group Executive Committee (GEC)	Assists the Group Chief Executive in exercising his authority in relation to material matters having strategic, cross-business area or Group-wide implications.
Group Risk Committee (GRC)	Responsible for the development, implementation and effectiveness of the Group's Risk Management Framework, the clear articulation of the Group's risk appetite and monitoring and reviewing of the Group's aggregate risk exposures and concentrations of risk.
Group Asset and Liability Committee (GALCO)	Responsible for the strategic direction of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. The committee reviews and determines the appropriate allocation of capital, funding and liquidity and market risk resources and makes appropriate trade-offs between risk and reward.
Group Customer First Committee	Provides a Group-wide perspective on the progress of implementation of initiatives to enhance the delivery of customer outcomes and customer trust, and sets and promotes the appropriate

	tone from the top to fulfil the Group's vision.
Group Cost Management Committee	Leads and shapes the Group's approach to cost management, ensuring appropriate governance and process over Group-wide cost management activities and effective control of the Group's cost base.
Conduct Review Committee	Provides senior management oversight, challenge and accountability in connection with the Group's engagement with conduct review matters as agreed with the Group Chief Executive.
Group People Committee	Oversees the Group's colleague policy, remuneration policy and Group-wide remuneration matters, oversees compliance with Senior Manager and Certification Regime (SM&CR) and other regulatory requirements, monitors colleague engagement surveys and ensures that colleague-related issues are managed fairly, effectively and compliantly.
Sustainability Committee	Recommends and implements the strategy and plans for delivering the Group's aspiration to be viewed as a trusted responsible business as part of the objective of Helping Britain Prosper.
Senior Independent Performance Adjustment and Conduct Committee	Responsible for providing recommendations regarding performance adjustment, including the individual risk-adjustment process and risk-adjusted performance assessment, and making final decisions on behalf of the Group on the appropriate course of action relating to conduct breaches, under the formal scope of the SM&CR.
Group Strategic Review 3 Committee	Responsible for monitoring the progress of transformation across the Group, acting as a clearing house to resolve issues and facilitate resolution of issues where necessary and to drive the execution of the Group's transformation agenda as agreed by the Group Chief Executive.

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

Credit Risk Committees	Review material credit risk, both current and emerging, and adherence to agreed risk appetite; approve or note the delegated approval of divisional and business level credit risk policy and credit risk appetite; identify portfolio trends and risk appetite breaches and escalate to Group Risk Committee as appropriate; sanction new credit initiatives for automated and manual decisioning and collection and recoveries; oversight new business and portfolio credit risk performance, risks, opportunities, and concentrations; and oversight performance of collections and recoveries.
Group Market Risk Committee	Reviews and recommends market risk appetites. Monitors and oversights market risk exposures across the Group and adherence to Board Risk Appetite. Approves the framework and designation of books between the Trading Book and the Banking Book for regulatory purposes.
Group Conduct, Compliance and Operational Risk Committee	Acts as a Risk community forum to independently challenge and oversee the Group-wide risk and control environment, focusing on read-across of material events, key areas of regulatory focus and emerging horizon risks. Uses lessons learned and undertakes read-across from the three lines of defence to ensure that the Group-wide risk profile adapts to emerging risks, trends and themes, and the control environment is sustainable to deliver the Bank of the Future.

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Committees	**Risk focus**
Group Fraud and Financial Crime Prevention Committee	Ensures development and application of fraud and financial crime risk management complies with the Group's strategic aims, Group Corporate Responsibility, Group Risk Appetite and Group Fraud and Financial Crime Policies. Provides direction and appropriate focus on priorities to enhance the Group's fraud and financial crime risk management capabilities in line with business and customer objectives whilst aligning to the Group's target operating model.
Group Financial Risk Committee	Responsible for oversighting, reviewing, challenging and recommending to senior executives and Board committees internal and Regulatory stress tests, Internal Capital Adequacy Assessment Process, Pillar 3 Disclosures, Recovery and Resolution Plans, and other analysis as required.
Group Capital Risk Committee	Responsible for providing oversight of all relevant capital matters within the Group including the Group's latest capital position and plans, risk appetite proposals, Pillar 2 developments, and the impact from regulatory reforms and accounting developments specific to capital.
Group Model Governance Committee	Responsible for setting the model governance framework, the associated policy and related principles and procedures; reviewing and approving models, model changes, model extensions and capital post model adjustments; recommending approval to Group Risk Committee (GRC) of those models which require GRC approval; monitoring summary of model performance, approving any appropriate corrective actions; and monitoring performance against risk appetite and escalating as required.
Ring-Fenced Bank Perimeter Oversight Committee	The Committee escalates perimeter control breaches to the Ring-Fenced Banks' Board Risk Committee and Boards.

FULL ANALYSIS OF RISK CATEGORIES

The Group's risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. A detailed description of each category is provided on pages 51 to 103.

Risk categories recognised by the Group are periodically reviewed to ensure that they reflect the Group risk profile in light of internal and external factors, such as the Group Strategy and the regulatory environment in which it operates. As part of a review of the Group's risk categories, the secondary risk categories in the table below of Change, Data management and Operational resilience have been elevated to primary risk categories, and Strategic risk has been included as a new primary risk category, in the Group's Risk Management Framework. These changes will be embedded during 2019.

Primary risk categories	**Secondary risk categories**	
Credit risk Page 51	– Retail credit	– Commercial credit

Regulatory and legal risk Page 75	– Regulatory compliance	– Legal	
Conduct risk Page 75	– Conduct		
Operational risk	– Business process	– External service provision	– Internal service provision
Page 76	– Change	– Financial crime	– IT systems
	– Cyber and information security	– Financial reporting	– Operational resilience
	– Data management	– Fraud	– Physical security/health and safety
	– Sourcing		
People risk Page 78	– People		
Insurance underwriting risk Page 78	– Insurance underwriting		
Capital risk Page 79	– Capital		
Funding and liquidity risk Page 88	– Funding and liquidity		
Governance risk Page 95	– Governance		
Market risk Page 96	– Trading book – Banking book	– Pensions – Insurance	
Model risk Page 102	– Model		

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

CREDIT RISK

DEFINITION

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

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances, contingent liabilities, commitments, debt securities and derivatives to customers, financial institutions and sovereigns. The credit risk exposures of the Group are set out in note 52 on page F-88.

In terms of loans and advances (for example mortgages, term loans and overdrafts) and contingent liabilities (for example credit instruments such as guarantees and documentary letters of credit), credit risk arises both from amounts advanced and commitments to extend credit to a customer or bank. With respect to commitments to extend credit, the Group is potentially exposed to a loss up to an amount equal to the total unutilised commitments. However, the likely amount of loss may be less than the total unutilised commitments, as most retail and certain commercial lending commitments may be cancelled based on regular assessment of the prevailing creditworthiness of customers. Most commercial term commitments are also contingent upon customers maintaining specific credit standards.

Credit risk also arises from debt securities and derivatives. The total notional principal amount of interest rate, exchange rate, credit derivative and other contracts outstanding at 31 December 2018 is shown on page 64. The notional principal amount does not, however, represent the Group’s credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 52 on page F-88.

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

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

The investments held in the Group's defined benefit pension schemes also expose the Group to credit risk. Note 35 on page F-52 provides further information on the defined benefit pension schemes' assets and liabilities.

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

MEASUREMENT

The process for credit risk identification, measurement and control is integrated into the Board-approved framework for credit risk appetite and governance.

Credit risk is measured from different perspectives using a range of appropriate modelling and scoring techniques at a number of levels of granularity, including total balance sheet, individual portfolio, pertinent concentrations and individual customer – for both new business and existing lending. Key metrics such as total exposure, risk-weighted assets, new business quality, concentration risk and portfolio performance, are reported monthly to Risk Committees.

Measures such as expected credit loss (ECL), risk-weighted assets, observed credit performance, predicted credit quality (usually from predictive credit scoring models), collateral cover and quality and other credit drivers (such as cash flow, affordability, leverage and indebtedness) are used to enable effective risk measurement across the Group.

In addition, stress testing and scenario analysis are used to estimate impairment losses and capital demand forecasts for both regulatory and internal purposes and to assist in the formulation of credit risk appetite.

As part of the 'three lines of defence' model, Risk division is the second line of defence providing oversight and independent challenge to key risk decisions taken by business management. Risk division also tests the effectiveness of credit risk management and internal credit risk controls. This includes ensuring that the control and monitoring of higher risk and vulnerable portfolios/sectors is appropriate and confirming that appropriate loss allowances for impairment are in place. Output from these reviews help to inform credit risk appetite and credit policy.

As the third line of defence, Group Internal Audit undertakes regular risk-based reviews to assess the effectiveness of credit risk management and controls. The Group's external auditors also review adequacy at each quarter-end.

Following the introduction of IFRS 9, underlying processes and key controls have been updated with additional management information produced to assist in monitoring portfolio quality and provision coverage. Group governance and oversight of impairments remains largely unchanged.

MITIGATION

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

Prudent, through the cycle credit principles, risk policies and appetite statements: the independent Risk division sets out the credit principles, credit risk policies and credit risk appetite statements. These are subject to regular review and governance, with any changes subject to an approval process. Risk teams monitor credit performance trends, review and challenge exceptions and test the adequacy and adherence to credit risk policies and processes throughout the Group. This includes tracking portfolio performance against an agreed set of credit risk appetite tolerances.

Robust models and controls: see Model risk on page 102.

Limitations on concentration risk: there are portfolio controls on certain industries, sectors and products to reflect risk appetite as well as individual, customer and bank limit risk tolerances. Credit policies and appetite statements are aligned to the Group's risk appetite and restrict exposure to higher risk countries and potentially vulnerable sectors and asset classes. Note 52 on page F-88 provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent both an excessive concentration of risk and single name concentrations. These concentration risk controls are not necessarily in the form of a maximum limit on exposure, but may instead require new business in concentrated sectors to fulfil additional minimum policy and/or guideline requirements. The Group's largest exposures are regularly monitored by the Board Risk Committee and reported in accordance with regulatory requirements.

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

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Specialist expertise: credit quality is managed and controlled by a number of specialist units within the business and Risk division, which provide for example: intensive management and control; security perfection; maintenance of customer and facility records; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market segments and product ranges offered by the Group.

Stress testing: the Group's credit portfolios are subject to regular stress testing. In addition to the Group led, PRA, EBA and other regulatory stress tests, exercises focused on individual divisions and portfolios are also performed. For further information on stress testing process, methodology and governance see page 45.

Frequent and robust credit risk oversight and assurance: oversight and assurance of credit risk is undertaken by independent credit risk oversight functions operating within Retail credit risk and Commercial banking risk which are part of the Group's second line of defence. Their primary objective is to provide reasonable and independent oversight that credit risk is being effectively managed and to ensure that appropriate controls are in place and being adhered to. Group Internal Audit also provides assurance to the Board Audit Committee on the effectiveness of credit risk management controls across the Group's activities.

Collateral

The principal types of acceptable collateral include:

- residential and commercial properties;
- charges over business assets such as premises, inventory and accounts receivable;
- financial instruments such as debt securities;
- vehicles;
- cash; and
- guarantees received from third-parties.

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

For non-mortgage retail lending to small businesses, collateral may include second charges over residential property and the assignment of life cover.

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

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

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor and type of underlying transaction. Although lending decisions are based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted. This will have a financial impact on the amount of net interest income recognised and on internal loss given default estimates that contribute to the determination of asset quality and returns.

Collateral values are assessed at the time of loan origination. The Group requires collateral to be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. In certain circumstances, for Retail residential mortgages this may include the use of automated valuation models based on market data, subject to accuracy criteria and LTV limits. Where third-parties are used for collateral valuations, they are subject to regular monitoring and review. Collateral values are subject to review, which will vary according to the type of lending, collateral involved and account performance. Such reviews are undertaken to confirm that the value recorded remains appropriate and whether revaluation is required, considering for example, account performance, market conditions and any information available that may indicate that the value of the collateral has materially declined. In such instances, the Group may seek additional collateral and/or other amendments to the terms of the facility. The Group adjusts estimated market values to take account of the costs of realisation and any discount associated with the realisation of the collateral when estimating credit losses.

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

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

Refer to note 52 on page F-88 for further information on collateral.

Additional mitigation for Retail customers

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

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

In addition, the Group has in place quantitative limits such as maximum limits for individual customer products, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are policy limits above which the Group will typically reject borrowing applications. The Group also applies certain criteria that are applicable to specific products for example applications for buy-to-let mortgages.

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

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

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

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

Additional mitigation for Commercial customers

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

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

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

Master netting agreements

It is credit policy that a Group approved master netting agreement must be used for all derivative and traded product transactions and must be in place prior to trading. This requirement extends to trades with clients and the counterparties used for the Bank's own hedging activities, which may also include clearing trades with Central Counterparties (CCPs). Any exceptions must be approved by the appropriate credit sanctioner. Master netting agreements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis. However, within relevant jurisdictions and for appropriate counterparty types master netting agreements do reduce the credit risk to the extent that, if an event of default occurs, all trades with the counterparty may be terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since this is the net position of all trades under the master netting agreement.

Other credit risk transfers

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

MONITORING

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

Models

The performance of all models used in credit risk is monitored in line with the Group's governance framework – see Model risk on page 102.

Intensive care of customers in financial difficulty

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

Forbearance

The Group's aim in offering forbearance and other assistance to customers in financial distress is to benefit both the customer and the Group by supporting its customers and acting in their best interests by, where possible, bringing customer facilities back into a sustainable position.

The Group offers a range of tools and assistance to support customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being appropriate and sustainable for both the customer and the Group.

The provision and review of such assistance is controlled through the application of an appropriate policy framework and associated controls. Regular review of the assistance offered to customers is undertaken to confirm that it remains appropriate, alongside monitoring of customers' performance and the level of payments received.

The Group classifies accounts as forborne at the time a customer in financial difficulty is granted a concession. Accounts are classified as forborne for a minimum of two or three years, dependent on whether the exposure is performing or non-performing when the concession is applied.

Forbearance measures consist of concessions towards a debtor that is experiencing or about to experience difficulties in meeting its financial commitments. This can include modification of the previous terms and conditions of a contract or a total or partial refinancing of a troubled debt contract, either of which would not have been required had the debtor not been experiencing financial difficulties.

Non-performing exposures can be reclassified as Performing Forborne after a minimum 12 month cure period, providing there are no past due amounts or concerns regarding the full repayment of the exposure. A minimum of a further 24 months must pass from the date the forborne exposure was reclassified as Performing Forborne before the account can exit forbearance. If conditions to exit forbearance are not met at the end of this probation period, the exposure shall continue to be identified as forborne until all the conditions are met.

The Group's treatment of loan renegotiations is included in the impairment policy in note 2(H) on page F-13.

Customers receiving support from UK government sponsored programmes

To assist customers in financial distress, the Group participates in UK government sponsored programmes for households, including the Income Support for Mortgage Interest programme, under which the government paid all or part of the interest on the mortgage on behalf of the customer. The Income Support for Mortgage Interest programme changed from a benefit to a government loan, with effect from 6 April 2018. The Group estimates that customers representing approximately £0.4 billion (2017: £1.6 billion) of its mortgage exposures are receiving such support.

THE GROUP CREDIT RISK PORTFOLIO IN 2018

Overview

– Credit quality remains strong with no deterioration in credit risk. Flow to arrears remains stable at low levels. The Group's loan portfolios continue to be well positioned, reflecting the Group's continued prudent, through the cycle approach to credit risk and benefiting from continued low interest rates and a resilient UK economy.

– The gross asset quality ratio remains stable at 28 basis points, in line with 2017 and 2016.

– The net asset quality ratio increased to 21 basis points (2017: 18 basis points) and the impairment charge increased to £937 million in 2018 (2017: £795 million), driven by expected lower releases and write-backs, the inclusion of MBNA for a full year and a low impairment charge in Secured compared to one-off write-backs in 2017.

– The closed mortgage book continued to run off, reducing by a further £2.4 billion during 2018.

– Stage 2 loans as a proportion of total loans and advances to customers have reduced to 5.2 per cent (1 January 2018: 8.0 per cent), with Stage 2 loans and advances down by £11.9 billion to £25.3 billion driven by the sale of the Irish mortgage portfolio, model refinements to the Stage 2 transfer approach for Secured and portfolio improvements. Coverage of Stage 2 drawn balances increased to 4.2 per cent (1 January 2018: 3.4 per cent).

– Stage 3 loans as a proportion of total loans and advances to customers have remained broadly stable at 1.2 per cent (1 January 2018: 1.1 per cent), with Stage 3 loans and advances up £0.6 billion to £5.7 billion. Coverage of Stage 3 drawn balances decreased to 28.4 per cent (1 January 2018: 29.8 per cent).

Low risk culture and prudent risk appetite

– The Group continues to take a prudent approach to credit risk, with robust credit quality and affordability controls at origination and a prudent through the cycle credit risk appetite.

– Credit portfolios are well positioned against an uncertain economic outlook and potential market volatility, including that related to the UK's exit from the EU.

– The Group continues to grow lending to targeted segments while maintaining a prudent risk appetite.

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

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

Table 1.4: Group impairment charge

	Loans and advances to banks and other assets £m	**Loans and advances to customers £m**	**Financial assets at fair value through other comprehensive income £m**	**Undrawn balances £m**	**2018 Total £m**
Retail	–	889	–	(27)	862
Commercial Banking	1	150	(14)	(45)	92
Insurance and Wealth	–	1	–	–	1
Central Items	1	(18)	–	(1)	(18)
Total impairment charge	2	1,022	(14)	(73)	937
Asset quality ratio					0.21%
Gross asset quality ratio					0.28%

Table 1.5: **Group total expected credit loss allowance**

	At 31 Dec 2018 £m	At 1 Jan 2018 £m	At 31 Dec 2017[1] £m
Customer related balances			
Drawn	**3,150**	3,223	2,201
Undrawn	**193**	273	30
	3,343	3,496	2,231
Other assets	**19**	37	26
Total ECL allowance	**3,362**	3,533	2,257

1 Prior period comparatives are on an IAS 39 basis.

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Group loans and advances to customers

The following pages contain analysis of the Group's loans and advances to customers by sub-portfolio. Loans and advances to customers are categorised into the following stages:

Stage 1 assets comprise newly originated assets (unless purchased or originated credit impaired), as well as those which have not experienced a significant increase in credit risk. These assets carry an expected credit loss (ECL) allowance equivalent to the ECL that results from those default events that are possible within 12 months of the reporting date (12 month ECL).

Stage 2 assets are those which have experienced a significant increase in credit risk since origination. These assets carry an ECL equivalent to the ECL arising over the lifetime of the asset (lifetime ECL).

Stage 3 assets have either defaulted or are otherwise considered to be credit impaired. These assets carry a lifetime ECL.

Purchased or originated credit impaired assets (POCI) are those that have been originated or acquired in a credit impaired state. This includes within the definition of credit impaired the purchase of a financial asset at a deep discount that reflects impaired credit losses.

Table 1.6: **Group loans and advances to customers**

	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Purchased or originated credit-impaired £m	Stage 3 as % of total %
At 31 December 2018[1]						
Retail	**341,682**	**305,160**	**18,741**	**2,390**	**15,391**	**0.7**
Commercial Banking	**101,890**	**92,002**	**6,592**	**3,296**	**–**	**3.2**
Insurance and Wealth	**865**	**804**	**6**	**55**	**–**	**6.4**
Central items	**43,571**	**43,565**	**6**	**–**	**–**	**–**
Total gross lending	**488,008**	**441,531**	**25,345**	**5,741**	**15,391**	**1.2**
ECL allowances on drawn balances	**(3,150)**	**(525)**	**(994)**	**(1,553)**	**(78)**	

Net balance sheet carrying value	**484,858**	**441,006**	**24,351**	**4,188**	**15,313**	
ECL allowance (drawn and undrawn) as a percentage of gross lending (%)[2]	**0.7**	**0.1**	**4.2**	**28.4**		
At 1 January 2018[1,3]						
Retail	341,661	296,264	25,319	2,105	17,973	0.6
Commercial Banking	100,820	90,341	7,765	2,714	–	2.7
Insurance and Wealth	819	724	67	28	–	3.4
Central items	20,939	16,552	4,094	293	–	1.4
Total gross lending	464,239	403,881	37,245	5,140	17,973	1.1
ECL allowances on drawn balances	(3,223)	(597)	(1,148)	(1,446)	(32)	
Net balance sheet carrying value	461,016	403,284	36,097	3,694	17,941	
ECL allowance (drawn and undrawn) as a percentage of gross lending (%)[2]	0.8	0.2	3.4	29.8		

1 Gross lending and ECL allowances on drawn balances are stated on an IFRS 9 basis; the balances include the impact of the HBOS and MBNA acquisition related adjustments.

2 Total and Stage 3 expected credit loss allowances as a percentage of drawn balances are calculated excluding loans in recoveries for Retail (31 December 2018: £250 million; 1 January 2018: £291 million).

3 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.7: **Group expected credit loss allowances (drawn and undrawn) as a percentage of loans and advances to customers**

	Total		Stage 1		Stage 2		Stage 3		Purchased or originated credit-impaired	
	£m	as % of drawn balances %	£m	as % of drawn balances %	£m	as % of drawn balances %	£m	as % of drawn balances[1] %	£m	as % of drawn balances %
At 31 December 2018[2]										
Retail	**1,768**	**0.5**	**493**	**0.2**	**713**	**3.8**	**484**	**22.6**	**78**	**0.5**
Commercial Banking	**1,513**	**1.5**	**111**	**0.1**	**338**	**5.1**	**1,064**	**32.3**	**–**	**–**
Insurance and Wealth	**18**	**2.1**	**6**	**0.7**	**1**	**16.7**	**11**	**20.0**	**–**	**–**
Central items	**44**	**0.1**	**38**	**0.1**	**6**	**100.0**	**–**	**–**	**–**	**–**
Total	**3,343**	**0.7**	**648**	**0.1**	**1,058**	**4.2**	**1,559**	**28.4**	**78**	**0.5**
At 1 January 2018[2]										
Retail	1,685	0.5	538	0.2	716	2.8	399	22.0	32	0.2
Commercial Banking	1,521	1.5	132	0.1	432	5.6	957	35.3	–	–
Insurance and Wealth	17	2.1	6	0.8	2	3.0	9	32.1	–	–
Central items	273	1.3	67	0.4	125	3.1	81	27.6	–	–
Total	3,496	0.8	743	0.2	1,275	3.4	1,446	29.8	32	0.2

1 Total and Stage 3 ECL allowances as a percentage of drawn balances are calculated excluding loans in recoveries for Retail (31 December 2018: £250 million; 1 January 2018: £291 million).

2 Gross lending and ECL allowances on drawn balances are stated on an IFRS 9 basis; the balances include the impact of the HBOS and MBNA related acquisition adjustments.

Table 1.8: **Group Stage 2 loans and advances to customers**

	Up to date			**1-30 days past due**			**Over 30 days past due**		
	Gross lending £m	**Expected credit loss £m**	**As % of gross lending %**	**Gross lending £m**	**Expected credit loss £m**	**As % of gross lending %**	**Gross lending £m**	**Expected credit loss £m**	**As % of gross lending %**
At 31 December 2018[1]									
Retail	**14,505**	**498**	**3.4**	**2,441**	**113**	**4.6**	**1,795**	**102**	**5.7**
Commercial Banking	**6,020**	**287**	**4.8**	**455**	**42**	**9.2**	**117**	**9**	**7.7**
Insurance and Wealth	**4**	**–**	**–**	**–**	**–**	**–**	**2**	**1**	**50.0**

Central items	**6**	**6**	**100.0**	**–**	**–**	**–**	**–**	**–**	**–**
Total	**20,535**	**791**	**3.9**	**2,896**	**155**	**5.4**	**1,914**	**112**	**5.9**
At 1 January 2018[1,2]									
Retail	21,773	535	2.5	2,005	90	4.5	1,541	91	5.9
Commercial Banking	7,420	401	5.4	250	31	12.4	95	–	–
Insurance and Wealth	61	2	3.3	1	–	–	5	–	–
Central items	4,014	111	2.8	62	10	16.1	18	4	22.2
Total	33,268	1,049	3.2	2,318	131	5.7	1,659	95	5.7

1 Gross lending and ECL allowances on drawn balances are stated on an IFRS 9 basis; the balances include the impact of the HBOS and MBNA acquisition related adjustments.

2 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

The Group's assessment of a significant increase in credit risk, and resulting categorisation of Stage 2, includes customers moving into early arrears as well as a broader assessment that an up to date customer has experienced a level of deterioration in credit risk since origination. A more sophisticated assessment is required for up to date customers, which varies across divisions and product type. This assessment incorporates specific triggers such as a significant proportionate increase in probability of default relative to that at origination, recent arrears, forbearance activity, internal watch lists and external bureau flags. Up to date exposures in Stage 2 are likely to show lower levels of expected credit loss (ECL) allowance relative to those that have already moved into arrears given that an arrears status typically reflects a stronger indication of future default and greater likelihood of credit losses.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Retail

- The credit quality of the Retail portfolios remains strong and continues to benefit from robust credit risk management, including affordability and indebtedness controls at origination and a prudent approach to risk appetite. The economic environment remains resilient with record employment rates, falling inflation, positive real wage growth and household indebtedness remaining below pre-crisis levels.

  - New business quality remains strong;

  - The flow of loans entering arrears remains at low levels;

  - Stage 3 balances are broadly flat at 0.7 per cent; and

  - Stage 2 balances have reduced to 5.5 per cent of the portfolio, largely due to model refinements to the Stage 2 transfer approach for Secured.

- Loans and advances remained flat during the period at £342 billion as of 31 December 2018.

- The impairment charge increased by £151 million (21.2 per cent) to £862 million for 2018 (2017: £711 million). The increase is attributable to the inclusion of MBNA for a full year and a low impairment charge in Secured compared to one-off write-backs in 2017.

- Expected credit loss (ECL) allowance as a percentage of drawn balances for Stage 3 increased to 22.6 per cent from 22.0 per cent relating to prudent provisioning in Secured. Coverage for Stage 2 has increased to 3.8 per cent from 2.8 per cent, largely due to model refinements to the Stage 2 transfer approach for Secured resulting in a reclassification of better quality Stage 2 assets into Stage 1.

Table 1.9: **Retail impairment charge**

	2018
	£m
Secured	**38**
Unsecured[1]	**683**
UK Motor Finance	**113**
Other[2]	**28**
Total impairment charge	**862**
Asset quality ratio	**0.25%**

1 Unsecured includes Credit cards, Loans and Overdrafts.

2 Other includes Business Banking, Europe and Retail run-off.

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

	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Purchased or originated credit-impaired £m	Stage 3 as % of total %
At 31 December 2018[1]						
Secured	**288,235**	**257,797**	**13,654**	**1,393**	**15,391**	**0.5**
Unsecured[2]	**28,115**	**24,705**	**2,707**	**703**	**–**	**2.5**
UK Motor Finance	**14,933**	**13,224**	**1,580**	**129**	**–**	**0.9**
Other[3]	**10,399**	**9,434**	**800**	**165**	**–**	**1.6**
Total gross lending	**341,682**	**305,160**	**18,741**	**2,390**	**15,391**	**0.7**
ECL allowances on drawn balances	**(1,613)**	**(389)**	**(662)**	**(484)**	**(78)**	
Net balance sheet carrying value	**340,069**	**304,771**	**18,079**	**1,906**	**15,313**	
ECL allowances (drawn and undrawn) as a percentage of gross lending (%)[4]	**0.5**	**0.2**	**3.8**	**22.6**		
At 1 January 2018[1,5]						
Secured	291,021	251,707	20,109	1,232	17,973	0.4
Unsecured[2]	27,886	24,197	3,052	637	–	2.3
UK Motor Finance	13,738	12,176	1,456	106	–	0.8
Other[3]	9,016	8,184	702	130	–	1.4
Total gross lending	341,661	296,264	25,319	2,105	17,973	0.6
ECL allowances on drawn balances	(1,495)	(424)	(640)	(399)	(32)	
Net balance sheet carrying value	340,166	295,840	24,679	1,706	17,941	
ECL allowances (drawn and undrawn) as a percentage of gross lending (%)	0.5	0.2	2.8	22.0		

1 Gross lending and ECL allowances on drawn balances are stated on an IFRS 9 basis; the balances include the impact of the HBOS and MBNA acquisition related adjustments.

2 Unsecured includes Credit cards, Loans and Overdrafts.

3 Other includes Business Banking, Europe and Retail run-off.

4 Total and Stage 3 ECL allowances as a percentage of drawn balances are calculated excluding loans in recoveries for Unsecured (31 December 2018: £233 million; 1 January 2018: £277 million) and Business Banking within Other (31 December 2018: £17 million; 1 January 2018: £14 million).

5 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

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Table 1.11: **Retail expected credit loss allowances (drawn and undrawn) as a percentage of loans and advances to customers**

	Total		**Stage 1**		**Stage 2**		**Stage 3**		**Purchased or originated credit-impaired £m**	
	£m	**As % of drawn balances %**	**£m**	**As % of drawn balances %**	**£m**	**As % of drawn balances %**	**£m**	**As % of drawn balances[1] %**	**£m**	**As % of drawn balances %**
At 31 December 2018[2]										
Secured	**460**	**0.2**	**38**	**–**	**226**	**1.7**	**118**	**8.5**	**78**	**0.5**
Unsecured[3]	**896**	**3.2**	**287**	**1.2**	**379**	**14.0**	**230**	**48.9**	**–**	**–**
UK Motor Finance[4]	**290**	**1.9**	**127**	**1.0**	**78**	**4.9**	**85**	**65.9**	**–**	**–**
Other[5]	**122**	**1.2**	**41**	**0.4**	**30**	**3.8**	**51**	**34.5**	**–**	**–**
Total	**1,768**	**0.5**	**493**	**0.2**	**713**	**3.8**	**484**	**22.6**	**78**	**0.5**
At 1 January 2018[2,6]										
Secured	385	0.1	31	–	236	1.2	86	7.0	32	0.2
Unsecured[3]	933	3.3	350	1.4	382	12.5	201	55.8	–	–
UK Motor Finance[4]	258	1.9	113	0.9	73	5.0	72	67.9	–	–
Other[5]	109	1.2	44	0.5	25	3.6	40	34.5	–	–
Total	1,685	0.5	538	0.2	716	2.8	399	22.0	32	0.2

1 Total and Stage 3 ECL allowance as a percentage of drawn balances are calculated excluding loans in recoveries for Unsecured (31 December 2018: £233 million; 1 January 2018: £277 million), and Business Banking within Other (31 December 2018: £17 million; 1 January 2018: £14 million).

2 Gross lending and ECL allowances on drawn balances are stated on an IFRS 9 basis; the balances include the impact of the HBOS and MBNA related acquisition adjustments.

3 Unsecured includes Credit cards, Loans and Overdrafts.

4 UK Motor Finance for Stages 1 and 2 include £99 million (1 January 2018: £84 million) relating to provisions against residual values of vehicles subject to finance leasing agreements. These provisions are included within the calculation of coverage ratios.

5 Other includes Business Banking, Europe and Retail run-off.

6 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

Table 1.12: **Retail Stage 2 loans and advances to customers**

	Up to date			1-30 days past due			Over 30 days past due		
	Gross lending £m	Expected credit loss £m	As % of gross lending %	Gross lending £m	Expected credit loss £m	As % of gross lending %	Gross lending £m	Expected credit loss £m	As % of gross lending %
At 31 December 2018[1]									
Secured	**10,118**	**139**	**1.4**	**1,955**	**30**	**1.5**	**1,581**	**57**	**3.6**
Unsecured[2]	**2,355**	**293**	**12.4**	**258**	**53**	**20.5**	**94**	**33**	**35.1**
UK Motor Finance	**1,403**	**47**	**3.3**	**146**	**23**	**15.8**	**31**	**8**	**25.8**
Other[3]	**629**	**19**	**3.0**	**82**	**7**	**8.5**	**89**	**4**	**4.5**
Total	**14,505**	**498**	**3.4**	**2,441**	**113**	**4.6**	**1,795**	**102**	**5.7**
At 1 January 2018[1,4]									
Secured[5]	17,264	172	1.0	1,506	20	1.3	1,339	44	3.3
Unsecured[2]	2,678	303	11.3	253	43	17.0	121	36	29.8
UK Motor Finance	1,279	45	3.5	137	21	15.3	40	7	17.5
Other[3]	552	15	2.7	109	6	5.5	41	4	9.8
Total	21,773	535	2.5	2,005	90	4.5	1,541	91	5.9

1 Gross lending and ECL allowances on drawn balances are stated on an IFRS 9 basis; the balances include the impact of the HBOS and MBNA related acquisition adjustments.

2 Unsecured includes Credit cards, Loans and Overdrafts.

3 Other includes Business Banking, Europe and Retail run-off.

4 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

5 Secured days past due segmentation restated to align with IFRS 9 classifications.

Portfolios

- Secured credit quality remained strong, with flow to arrears stable at low levels. The average indexed loan to value (LTV) remained stable at 44.1 per cent (1 January 2018: 43.6 per cent) and the proportion of balances with an LTV of greater than 90 per cent remained low at 2.9 per cent (1 January 2018: 2.5 per cent). The average LTV of new business improved to 62.5 per cent (31 December 2017: 63.0 per cent). The closed Specialist mortgage portfolio continued to run off, reducing by a further £1.7 billion (11.0 per cent). Total Secured loans and advances decreased by £2.8 billion (1.0 per cent) to £288 billion (1 January 2018: £291 billion), due to reductions in the Buy-to-let and closed Specialist portfolios. The impairment charge was £38 million compared to a release of £15 million in 2017 arising from one-off write-backs. Total expected credit loss allowance as a percentage of loans and advances (coverage) remained broadly flat.

- Unsecured loans and advances were broadly flat for the year ending 31 December 2018. The impairment charge increased by £91 million to £683 million (2017: £592 million), mainly due to the inclusion of MBNA for a full year. Coverage decreased slightly to 3.2 per cent at 31 December 2018 (1 January 2018: 3.3 per cent), with model refinements in Stage 2 offset by those in Stage 3.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The UK Motor Finance portfolio continued to grow, with loans and advances increasing by 8.7 per cent to £14.9 billion at 31 December 2018 (1 January 2018: £13.7 billion). Increases in Stage 2 and Stage 3 balances reflect growth in the retail portfolio. The impairment charge in the period was broadly flat at £113 million (2017: £111 million). The portfolio continues to benefit from a conservative approach to residual values at origination and through the loan lifecycle, with prudent residual value provisions accounting for £99 million of Stage 1 and Stage 2 expected credit loss allowance at 31 December 2018. Coverage for the portfolio was flat at 1.9 per cent.

Other loans and advances increased by £1.4 billion to £10.4 billion driven by a transfer of largely Stage 1 assets from SME into Business Banking. The impairment charge increased by £5 million to £28 million in the year due to the non-repeat of one-off write-backs in 2017 relating to a closed portfolio. Coverage remained flat at 1.2 per cent.

Table 1.13: **Retail secured loans and advances to customers**

	At 31 Dec 2018[1] £m	At 1 Jan 2018[1] £m
Mainstream	**223,230**	222,814
Buy-to-let	**51,322**	52,834
Specialist	**13,683**	15,373
Total	**288,235**	291,021

1 The balances include the impact of HBOS related acquisition adjustments.

Table 1.14: **Mortgages greater than three months in arrears (excluding repossessions)**

	Number of cases		**Total mortgage accounts**		**Value of loans[1]**		**Total mortgage balances**	
	2018	2017	**2018**	2017	**2018**	2017	**2018**	2017
At 31 December	**Cases**	Cases	**%**	%	**£m**	£m	**%**	%
Mainstream	**30,106**	32,383	**1.5**	1.6	**3,262**	3,502	**1.5**	1.6
Buy-to-let	**4,544**	4,710	**1.0**	1.0	**576**	581	**1.1**	1.1
Specialist	**7,966**	8,313	**7.8**	7.3	**1,282**	1,354	**9.3**	8.7
Total	**42,616**	45,406	**1.7**	1.7	**5,120**	5,437	**1.8**	1.9

1 Value of loans represents total gross book value of mortgages more than three months in arrears; the balances exclude the impact of HBOS related acquisition adjustments.

The stock of repossessions decreased to 763 cases at 31 December 2018 compared to 777 cases at 31 December 2017.

Table 1.15: **Period end and average LTVs across the Retail mortgage portfolios**

	Mainstream %	**Buy-to-let %**	**Specialist %**	**Total %**
At 31 December 2018				
Less than 60%	**54.2**	**55.7**	**59.7**	**54.7**
60% to 70%	**16.0**	**22.8**	**16.5**	**17.3**
70% to 80%	**15.9**	**15.7**	**12.0**	**15.7**
80% to 90%	**10.7**	**4.6**	**6.6**	**9.4**
90% to 100%	**2.8**	**0.7**	**2.0**	**2.4**
Greater than 100%	**0.4**	**0.5**	**3.2**	**0.5**
Total	**100.0**	**100.0**	**100.0**	**100.0**
Average loan to value[1]:				
Stock of residential mortgages	**42.5**	**52.1**	**45.8**	**44.1**
New residential lending	**63.1**	**58.6**	**n/a**	**62.5**

	Mainstream %	Buy-to-let %	Specialist %	Total %
At 31 December 2017				
Less than 60%	57.1	53.9	57.6	56.4
60% to 70%	16.9	25.0	18.4	18.5
70% to 80%	14.5	15.7	12.8	14.6
80% to 90%	9.0	4.1	6.4	8.0
90% to 100%	2.1	0.7	1.6	1.9
Greater than 100%	0.4	0.6	3.2	0.6
Total	100.0	100.0	100.0	100.0
Average loan to value[1]:				
Stock of residential mortgages	41.7	53.0	47.4	43.6
New residential lending	63.7	59.1	n/a	63.0

1 Average loan to value is calculated as total loans and advances as a percentage of the total indexed collateral of these loans and advances; the balances exclude the impact of HBOS related acquisition adjustments.

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Interest only mortgages

The Group provides interest only mortgages to owner occupier mortgage customers whereby only payments of interest are made for the term of the mortgage with the customer responsible for repaying the principal outstanding at the end of the loan term. At 31 December 2018, owner occupier interest only balances as a proportion of total owner occupier balances had reduced to 26.7 per cent (31 December 2017: 29.0 per cent). The average indexed loan to value improved to 41.3 per cent (31 December 2017: 41.7 per cent).

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

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

Table 1.16: **Analysis of owner occupier interest only mortgages**

	At 31 December 2018[1] **Total**	At 1 January 2018[1] Total
Interest only balances (£m)	**63,138**	69,129
Stage 1 (%)	**79.1**	75.4
Stage 2 (%)	**6.6**	9.5
Stage 3 (%)	**1.0**	0.8
Purchased or originated credit impaired (%)	**13.3**	14.3
Average loan to value (%)	**41.3**	41.7
Maturity profile (£m)		
Due	**1,144**	1,043
1 year	**2,405**	2,612
2-5 years	**10,229**	10,158
6-10 years	**18,562**	17,913
>11 years	**30,798**	37,403
Past term interest only balances (£m)[2]	**1,635**	1,474

Stage 1 (%)	**2.8**	2.9
Stage 2 (%)	**16.8**	15.3
Stage 3 (%)	**17.9**	15.6
Purchased or originated credit impaired (%)	**62.5**	66.2
Average loan to value (%)	**35.2**	33.4
Negative equity (%)	**2.8**	2.1

1 Balances are stated on an IFRS 9 basis and include the impact of HBOS acquisition related adjustments.

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

Retail forbearance

The basis of disclosure for forbearance has changed compared to previous years to be aligned to definitions used in the European Banking Authority's FINREP reporting. On a like-for-like basis, the change leads to an increase in disclosed forbearance of £5.6 billion, with the main drivers being longer probation periods before a customer can return to order and the inclusion of Past Term Interest Only for Secured.

The main customer treatments included are: repair, where arrears are written on to the loan balance and the arrears position cancelled; instances where there are suspensions of interest and/or capital repayments; Past Term Interest Only mortgages; and refinance personal loans.

Total forbearance for the major retail portfolios has improved by £569 million to £6.6 billion driven by customers exiting probation and returning to order on the Secured portfolio. As a percentage of loans and advances, forbearance loans improved to 2.1 per cent at 31 December 2018 (1 January 2018: 2.2 per cent). 98.0 per cent of forbearance loans are captured in Stage 2, Stage 3 or POCI and hold provision on a lifetime basis. Total expected credit losses (ECL) as a proportion of loans and advances which are forborne has increased to 3.6 per cent (1 January 2018: 3.2 per cent) due to prudent provisioning on the Secured portfolio.

The Group measures the success of a forbearance scheme for Retail Secured customers based upon the proportion of customers performing (less than or equal to three months in arrears) over the 24 months following the exit from a forbearance treatment. For temporary treatments, 80.4 per cent of UK Secured customers accepting reduced payment arrangements are performing. For permanent treatments, 83.2 per cent of UK Secured customers who have accepted capitalisations of arrears and 84.4 per cent of customers who have accepted term extensions are performing.

Table 1.17: **Retail forborne loans and advances (audited)**

	Total £m	Of which Stage 2 £m	Of which Stage 3 £m	Of which purchased or originated credit-impaired £m	Expected credit losses as a % of total loans and advances which are forborne[1] %
At 31 December 2018[2]					
Secured	**6,089**	**1,136**	**642**	**4,241**	**1.6**
Unsecured[3]	**435**	**173**	**200**	**–**	**27.8**
UK Motor Finance (Retail)	**56**	**30**	**25**	**–**	**34.8**
Total	**6,580**	**1,339**	**867**	**4,241**	**3.6**
At 1 January 2018[2]					
Secured	6,676	1,367	562	4,693	1.1
Unsecured[3]	422	130	230	–	32.7
UK Motor Finance (Retail)	51	26	24	–	36.1
Total	7,149	1,523	816	4,693	3.2

1 ECL as a percentage of total loans and advances which are forborne are calculated excluding loans in recoveries for Unsecured (31 December 2018: £107 million; 1 January 2018: £147 million).

2 The balances include the impact of HBOS related acquisition adjustments.

3 Excludes MBNA.

Commercial Banking

- The overall credit quality of the portfolio and new business remains good with the portfolio benefiting from effective risk management, a through the cycle approach to risk appetite and continued low interest rates. Notwithstanding the current competitive market conditions, the Group is maintaining its prudent risk appetite.

- Uncertainty persists around the UK and global economic outlook, including the outcome of EU exit negotiations, the sustainability of global economic growth, trade wars and geopolitical risks. Allied to this are headwinds in a number of sectors including construction, support services and consumer-related sectors, such as retail. However, the portfolios remain well positioned and the Group’s through the cycle risk appetite approach is unchanged. Monitoring indicates no material deterioration in the credit quality of the portfolio.

– Internal and external key performance indicators are monitored closely to help identify early signs of any deterioration. Portfolios remain subject to ongoing risk mitigation actions as appropriate.

– Planning for any EU exit outcome is well advanced and continues to evolve in Commercial Banking to ensure portfolio quality is maintained whilst supporting the Group's Helping Britain Prosper strategy.

– Net impairment charge for 2018 of £92 million compared with a net charge of £89 million in 2017.

– Stage 3 gross charges included the impact of IFRS 9 model refinements and were broadly flat year on year. Stage 3 net charges increased, driven by lower impairment releases and write-backs.

– Net impairment releases in Stage 1 and 2 were weighted towards non-SME portfolios and reflect a number of factors including transfers between stages (including to and from Stage 3), refinements to the IFRS 9 model methodology as well as adjustments to Multiple Economic Scenario impacts to reflect any changes to the underlying economic outlook.

– The size and nature of the commercial portfolio results in some volatility as cases move between stages. Stage 3 loans as a proportion of total loans and advances to customers has increased to 3.2 per cent (1 January 2018: 2.7 per cent). Stage 3 expected credit loss (ECL) allowance as a percentage of Stage 3 drawn balances has reduced to 32.3 per cent (1 January 2018: 35.3 per cent) largely as a result of a transfer in of assets to impaired status on which lower ECL allowances are assessed.

– Stage 2 loans as a proportion of total loans and advances to customers reduced to 6.5 per cent (1 January 2018: 7.7 per cent) as a result of transfers to Stage 1 and Stage 3. The proportion of Stage 1 loans increased to 90.3 per cent (1 January 2018: 89.6 per cent). Stage 2 ECL allowances as a percentage of Stage 2 drawn balances were lower at 5.1 per cent (1 January 2018: 5.6 per cent) due to changes in the mix of assets classified as Stage 2 and revisions to model assumptions.

– Notwithstanding the current stable performance of the portfolio, impairments are likely to increase from their current levels, driven mainly by lower levels of releases and write-backs and an element of credit normalisation.

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Table 1.18: **Commercial Banking impairment charge**

	2018	2017[1]	Change
	£m	£m	%
SME	**63**	7	
Other	**29**	82	
Total impairment charge	**92**	89	(3)
Asset quality ratio	**0.09%**	0.10%	(1)bp

1 Prior period comparatives are on an IAS 39 basis. Includes Run-off, previously reported as a separate segment.

Table 1.19: **Commercial Banking loans and advances to customers**

	Total £m	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Stage 3 as % of total %**
At 31 December 2018					
SME	**30,296**	**26,099**	**3,484**	**713**	**2.4**
Other	**71,594**	**65,903**	**3,108**	**2,583**	**3.6**
Total gross lending	**101,890**	**92,002**	**6,592**	**3,296**	**3.2**
ECL allowance on drawn balances	**(1,476)**	**(93)**	**(325)**	**(1,058)**	**–**
Net balance sheet carrying value	**100,414**	**91,909**	**6,267**	**2,238**	**–**
ECL allowances (drawn and undrawn) as a percentage of gross lending (%)	**1.5**	**0.1**	**5.1**	**32.3**	
At 1 January 2018[1]					
SME	30,510	26,397	3,262	851	2.8
Other	70,310	63,944	4,503	1,863	2.6
Total gross lending	100,820	90,341	7,765	2,714	2.7
ECL allowance on drawn balances	(1,440)	(101)	(382)	(957)	
Net balance sheet carrying value	99,380	90,240	7,383	1,757	
ECL allowances (drawn and undrawn) as a percentage of gross lending (%)	1.5	0.1	5.6	35.3	

1 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

Table 1.20: **Commercial Banking expected credit loss allowances (drawn and undrawn) as a percentage of loans and advances to customers**

	Total		**Stage 1**		**Stage 2**		**Stage 3**	
	£m	**As % of drawn balances %**	**£m**	**As % of drawn balances %**	**£m**	**As % of drawn balances %**	**£m**	**As % of drawn balances %**
At 31 December 2018								
SME	**384**	**1.3**	**40**	**0.2**	**231**	**6.6**	**113**	**15.8**
Other	**1,129**	**1.6**	**71**	**0.1**	**107**	**3.4**	**951**	**36.8**
Total	**1,513**	**1.5**	**111**	**0.1**	**338**	**5.1**	**1,064**	**32.3**
At 1 January 2018[1]								
SME	375	1.2	51	0.2	206	6.3	118	13.9
Other	1,146	1.6	81	0.1	226	5.0	839	45.0
Total	1,521	1.5	132	0.1	432	5.6	957	35.3

1 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

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Table 1.21: **Commercial Banking Stage 2 loans and advances to customers**

	Up to date			**1-30 days past due**			**Over 30 days past due**		
	Gross lending £m	**Expected credit loss £m**	**As % of gross lending %**	**Gross lending £m**	**Expected credit loss £m**	**As % of gross lending %**	**Gross lending £m**	**Expected credit loss £m**	**As % of gross lending %**
At 31 December 2018									
SME	**3,037**	**181**	**6.0**	**383**	**41**	**10.7**	**64**	**9**	**14.1**
Other	**2,983**	**106**	**3.5**	**72**	**1**	**1.4**	**53**	**–**	**–**
Total	**6,020**	**287**	**4.8**	**455**	**42**	**9.2**	**117**	**9**	**7.7**
At 1 January 2018[1]									
SME	2,969	180	6.1	227	26	11.5	66	–	–
Other	4,451	221	5.0	23	5	21.7	29	–	–
Total	7,420	401	5.4	250	31	12.4	95	–	–

1 Certain balances have been reallocated between segments. This includes the incorporation of International Wealth into Commercial Banking and the allocation of Run-off across Retail and Commercial Banking.

Portfolios

– The SME and Mid Markets portfolios are domestically focused and reflect both our prudent credit risk appetite and the underlying performance of the UK economy. Whilst certain sectors of the market are showing some emerging signs of stress, the overall credit quality of the portfolios has remained broadly stable with levels of impairment remaining low.

– The Global Corporates business continues to have a predominance of multi-national investment grade clients who are primarily UK-based. The portfolio remains of good quality and is well positioned for the current economic outlook.

– Through clearly defined sector strategies, Financial Institutions serves predominantly investment grade counterparties with whom relationships are either client driven or held to support the Group’s funding, liquidity or general hedging requirements.

– The commercial real estate business within the Group’s Mid Markets and Global Corporates portfolio is focused on clients operating in the UK commercial property market ranging in size from medium-sized private real estate entities up to publicly listed property companies. Credit quality remains good with minimal impairments/stressed loans. Recognising this is a cyclical sector, appropriate caps are in place to control exposure and business propositions continue to be written in line with a prudent, through the cycle risk appetite with conservative LTVs, strong quality of income and proven management teams.

Commercial Banking UK Direct Real Estate LTV analysis

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

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

– Commercial Banking UK Direct Real Estate gross lending stood at £17.2 billion at 31 December 2018 (excludes exposures subject to protection through Significant Risk Transfer securitisations). The Group has a further £0.54 billion of UK Direct Real Estate exposure in Business Banking within Retail.

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

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

– Development lending is subject to specific credit risk appetite criteria, including maximum loan to gross development value and maximum loan to cost, with funding typically only released against completed works as confirmed by the Group's monitoring quantity surveyor.

Table 1.22: **LTV – Commercial Banking UK Direct Real Estate**

	At 31 December 2018[1,2]				At 31 December 2017[1,2,3]			
	Stage 1/2 £m	**Stage 3 £m**	**Total £m**	**%**	Unimpaired £m	Impaired £m	Total £m	%
Investment Exposures > £1m								
Less than 60%	**8,838**	**101**	**8,939**	**79.8**	8,392	169	8,561	78.8
60% to 70%	**1,190**	**7**	**1,197**	**10.7**	1,012	20	1,032	9.5
70% to 80%	**267**	**41**	**308**	**2.7**	236	44	280	2.6
80% to 100%	**79**	**11**	**90**	**0.8**	74	42	116	1.1
100% to 120%	**27**	**25**	**52**	**0.5**	103	2	105	1.0
120% to 140%	**–**	**1**	**1**	**0.0**	61	2	63	0.6
Greater than 140%	**18**	**46**	**64**	**0.6**	22	49	71	0.7
Unsecured[4]	**520**	**31**	**551**	**4.9**	586	51	637	5.9
Total Investment >£1m	**10,939**	**263**	**11,202**		10,486	379	10,865	
Investment <£1m[5]	**3,679**	**105**	**3,784**		4,988	133	5,121	
Total Investment	**14,618**	**368**	**14,986**		15,474	512	15,986	
Development	**1,698**	**111**	**1,809**		1,655	147	1,802	
Total	**16,316**	**479**	**16,795**		17,129	659	17,788	

1 Excludes Commercial Banking UK Direct Real Estate exposures subject to protection through Significant Risk Transfer transactions.

2 Excludes Islands Commercial UK Direct Real Estate of £0.45 billion (31 December 2017: £0.45bn).

3 Prior period comparatives are on an IAS 39 basis. Includes run-off, previously excluded.

4 Predominantly Investment grade lending where the Group is relying on the corporate covenant.

5 December 2018 investment exposures <£1m have an LTV profile broadly similar to the investment exposures >£1m.
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Commercial Banking forbearance

Table 1.23: **Commercial Banking forborne loans and advances (audited)**

	Total £m	**Of which Stage 3 £m**
At 31 December 2018		
Type of forbearance		
Refinancing	**38**	**29**
Modification	**3,834**	**2,949**
Total	**3,872**	**2,978**
At 31 December 2017		
Type of forbearance		
Refinancing	27	
Modification	3,644	
Total	3,671	

Table 1.24: **Derivative credit risk exposures**

		2018 Traded over the counter				2017 Traded over the counter		
	Traded on recognised exchanges £m	**Settled by central counterparties £m**	**Not settled by central counterparties £m**	**Total £m**	Traded on recognised exchanges £m	Settled by central counterparties £m	Not settled by central counterparties £m	Total £m
Notional balances								
Foreign exchange	**–**	**45**	**385,680**	**385,725**	–	19	278,833	278,852
Interest rate	**128,221**	**4,950,912**	**689,882**	**5,769,015**	109,492	2,903,481	324,834	3,337,807
Equity and other	**9,247**	**–**	**5,898**	**15,145**	15,455	–	9,695	25,150
Credit	**–**	**–**	**13,757**	**13,757**	–	–	4,568	4,568
Total	**137,468**	**4,950,957**	**1,095,217**	**6,183,642**	124,947	2,903,500	617,930	3,646,377
Fair values								
Assets		**144**	**23,448**			280	25,155	

Liabilities	**(150)**	**(21,222)**	(592)	(25,454)
Net asset	**(6)**	**2,226**	(312)	(299)

The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2018 and 31 December 2017 is shown in the table above. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 52 on page F-88.

Eurozone exposures

The Group manages its exposures to individual countries, both within and without the Eurozone, through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected Eurozone countries Ireland, Spain, Italy and Greece by establishing and monitoring risk limits for individual banks, financial institutions, corporates and individuals.

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

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

Excluding reverse repurchase exposure to Institutional funds secured by UK gilts, the Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries Ireland, Spain, Portugal, Italy and Greece and following the £4 billion sale of the Irish residential mortgage portfolio during the year, exposures to the selected countries are significantly reduced.

Environmental risk management

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

The Group's business areas and sub-groups are each exposed to different types and levels of climate-related risk in their operations. For example, the general insurance function regularly uses weather, climate and environmental models and data to assess its insurance risk from covered perils such as windstorm and flood. A team of specialist scientists are employed within underwriting to do this work and they also regularly monitor the state of climate science to assess the need to include its potential impacts within pricing and solvency.

In 2018 we developed an implementation plan to address key recommendations of the Task Force on Climate-related Financial Disclosure (TCFD). Further detail on planned activities is provided in the Sustainability Strategy and Task Force on Climate-related Financial Disclosure Statement (see pages 6 to 7).

The Group has been a signatory to the Equator Principles since 2008 and has adopted and applied the expanded scope of Equator Principles III. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in Project Finance, Project-Related Corporate loans and Bridge loans. The Group has also been a signatory to the UN Principles for Responsible Investment (UNPRI) since 2012, which incorporate ESG (environmental, social and governance risk) considerations in asset management. Scottish Widows is responsible for the annual UNPRI reporting process.

Within Commercial Banking, an electronic Environmental Risk Screening Tool is the primary mechanism for assessing environmental risk for lending transactions. This system provides screening of location specific and sector based risks that may be present in a transaction. Where a risk is identified, the transaction is referred to the Group's expert in-house environmental risk team for further review and assessment. Where required, the Group's panel of environmental consultants provide additional expert support.

We provide colleague training on environmental risk management as part of the standard suite of Commercial Banking credit risk courses. To support this training, a range of online resource is available to colleagues and includes environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

Table 1.25: **Environmental risk management approach**

Group credit principles Environmental risk Credit policies Business unit processes Supporting tools Sector briefings Legislation briefings Initial transaction screening Relationship teams Detailed review In-house team, retained consultancy Environmental due diligence Panel consultants Environmental risk approval (including any conditions)

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LOAN PORTFOLIO

ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

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

	2018	2017	2016	2015	2014
	£m	£m	£m	£m	£m
Loans and advances to banks	6,285	6,611	26,902	25,117	26,155
Loans and advances to customers:					
Mortgages	297,498	304,665	306,682	312,877	333,318
Other personal lending	28,699	28,757	20,761	20,579	23,123
Agriculture, forestry and fishing	7,314	7,461	7,269	6,924	6,586
Energy and water supply	1,517	1,609	2,320	3,247	3,853
Manufacturing	8,260	7,886	7,285	5,953	6,000
Construction	4,684	4,428	4,535	4,952	6,425
Transport, distribution and hotels	14,113	14,074	13,320	13,526	15,112
Postal and telecommunications	2,711	2,148	2,564	2,563	2,624
Financial, business and other services	77,505	57,006	49,197	43,072	44,979
Property companies	28,451	30,980	32,192	32,228	36,682
Lease financing	1,822	2,094	2,628	2,751	3,013
Hire purchase	15,434	13,591	11,617	9,536	7,403
Total loans	494,293	481,310	487,272	483,325	515,273
Allowance for impairment losses[1]	(3,152)	(2,201)	(2,412)	(3,033)	(6,414)
Total loans and advances net of allowance for impairment losses	491,141	479,109	484,860	480,292	508,859

1 The allowance for loan losses at 31 December 2018 is measured in accordance with IFRS 9; for earlier years, it was determined in accordance with IAS 39.

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

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SUMMARY OF LOAN LOSS EXPERIENCE

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

	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m
Balance at end of preceding year	**2,201**	2,412	3,033	6,414	11,966
Adjustment on adoption of IFRS 9	**1,023**				
Balance at 1 January 2018	**3,224**				
Exchange and other adjustments	**126**	132	69	(246)	(410)
Disposal of businesses	**(181)**	–	–	(82)	–
Advances written off:					
Loans and advances to customers:					
Mortgages	**(12)**	(42)	(42)	(71)	(87)
Other personal lending	**(988)**	(925)	(728)	(853)	(1,329)
Agriculture, forestry and fishing	**(4)**	(1)	(1)	(1)	(8)
Energy and water supply	**–**	–	(9)	(73)	–
Manufacturing	**(11)**	(40)	(19)	(126)	(59)
Construction	**(82)**	(65)	(96)	(21)	(157)
Transport, distribution and hotels	**(42)**	(65)	(64)	(728)	(1,119)
Postal and telecommunications	**(2)**	–	(189)	(11)	–
Financial, business and other services	**(244)**	(158)	(712)	(604)	(946)
Property companies	**(134)**	(136)	(215)	(1,648)	(2,669)
Lease financing	**–**	(2)	–	(31)	(4)
Hire purchase	**(57)**	(65)	(36)	(37)	(54)
Loans and advances to banks	**–**	–	–	–	–
Total advances written off	**(1,576)**	(1,499)	(2,111)	(4,204)	(6,432)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	**20**	17	44	35	18
Other personal lending	**333**	419	329	366	600
Energy and water supply	**84**	–	3	5	–
Manufacturing	**10**	–	80	–	–
Construction	**65**	4	78	–	–
Transport, distribution and hotels	**9**	15	50	63	–
Postal and telecommunications	**1**	–	–	–	–
Financial, business and other services	**42**	6	241	193	–
Property companies	**16**	–	34	101	–
Lease financing	**–**	19	–	–	–
Hire purchase	**–**	2	2	1	63
Total recoveries of advances written off	**580**	482	861	764	681
Total net advances written off	**(996)**	(1,017)	(1,250)	(3,440)	(5,751)

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	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m
Effect of unwinding of discount recognised through interest income	**(44)**	(23)	(32)	(56)	(126)
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	**29**	(119)	(23)	33	(138)
Other personal lending	**699**	596	438	437	536
Agriculture, forestry and fishing	**10**	2	3	1	2
Energy and water supply	**(8)**	–	(4)	35	28
Manufacturing	**9**	5	(48)	23	(4)
Construction	**15**	85	143	13	(81)
Transport, distribution and hotels	**47**	(19)	(35)	(88)	198
Postal and telecommunications	**(2)**	1	191	(2)	6
Financial, business and other services	**79**	42	6	77	179
Property companies	**56**	(7)	(166)	(140)	40
Lease financing	**–**	–	15	31	(1)
Hire purchase	**88**	111	72	23	(30)
Loans and advances to banks	**1**	–	–	–	–
Total allowances for impairment losses charged against income for the year	**1,023**	697	592	443	735
Total balance at end of year	**3,152**	2,201	2,412	3,033	6,414
Ratio of net write-offs during the year to average loans outstanding during the year	**0.2%**	0.2%	0.3%	0.8%	1.1%

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

The Group's impairment allowances in respect of loans and advances to banks and customers increased by £951 million, or 9 per cent, from £2,201 million at 31 December 2017 to £3,152 million at 31 December 2018. However, an increase of £1,023 million arose on transition to IFRS 9 on 1 January 2018; adjusting for this the Group's impairment allowance in respect of loans and advances to banks and customers decreased by £72 million from £3,224 million at 1 January 2018 to £3,152 million at 31 December 2018. This decrease resulted from a charge to the income statement of £1,023 million being more than offset by net advances written off of £996 million (advances written off of £1,576 million less recoveries £580 million) together with a reduction of £181 million on sale of the Group's Irish mortgage portfolio. The increase in the charge to the income statement from £697 million in 2017 to £1,023 million in 2018 reflects lower levels of releases and write-backs and the impact of a full year's ownership of MBNA. By category of lending, the most significant elements of the charge to the income statement were charges of £699 million in respect of other personal lending, £79 million in respect of financial, business and other services and £88 million in respect of hire purchase. Of the net advances written off of £996 million, £655 million related to other personal lending, £202 million related to financial, business and other services and £118 million to property companies.

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

	2018 Allowance[1] £m	**2018 Percentage of loans in each category to total loans %**	2017 Allowance[1] £m	2017 Percentage of loans in each category to total loans %	2016 Allowance[1] £m	2016 Percentage of loans in each category to total loans %	2015 Allowance[1] £m	2015 Percentage loans in each category to total loans %	20 Al £r
Balance at year end applicable to:									
Loans and advances to banks	**2**	**1.3**	–	1.4	–	5.5	–	5.2	–
Loans and advances to customers:									
Mortgages	**509**	**60.1**	485	63.4	576	63.0	479	64.7	46
Other personal lending	**823**	**5.8**	381	6.0	356	4.3	388	4.3	60
Agriculture, forestry and fishing	**19**	**1.5**	8	1.6	13	1.5	15	1.4	18
Energy and water supply	**11**	**0.3**	5	0.3	6	0.5	20	0.7	61
Manufacturing	**65**	**1.7**	35	1.6	84	1.5	70	1.2	17
Construction	**514**	**0.9**	410	0.9	319	0.9	165	1.0	15
Transport, distribution and hotels	**161**	**2.9**	57	2.9	161	2.7	219	2.8	1,(
Postal and telecommunications	**10**	**0.5**	5	0.4	5	0.5	4	0.5	17
Financial, business and other services	**476**	**15.7**	312	11.9	312	10.1	811	8.9	1,
Property companies	**294**	**5.8**	343	6.4	470	6.6	790	6.7	2,
Lease financing	**–**	**0.4**	–	0.4	–	0.5	–	0.6	1
Hire purchase	**268**	**3.1**	160	2.8	110	2.4	72	2.0	84
Total balance at year end	**3,152**	**100.0**	2,201	100.0	2,412	100.0	3,033	100.0	6,

1 The allowance for loan losses at 31 December 2018 is measured in accordance with IFRS 9; for earlier years, it was determined in accordance with IAS 39.

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

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK ELEMENTS IN THE LOAN PORTFOLIO AND POTENTIAL PROBLEM LOANS

IFRS 9, which was adopted by the Group on 1 January 2018, requires that:

- interest is recognised on all loans and advances and, as a result, no loan is classified as non-accrual; and
- an allowance for expected credit losses is recognised on all loans and advances irrespective of whether any payments are past due.

As a result, the Group no longer analyses its loans between those that are neither past due nor impaired, past due but not impaired, impaired with no provision held and impaired with a provision.

Whilst IFRS 7 has been amended to recognise the impact of IFRS 9, it still requires detailed qualitative and quantitative disclosures about loan portfolios. The Group has revised its disclosures accordingly; the following tables are presented in respect of the Group's credit risk elements and potential problem loans.

	2018	2017 and earlier years
Analysis of impairment and provision status		ü
Days past due for loans and advances that are considered to have experienced a significant increase in credit risk, but are not credit-impaired	ü	
Days past due for loans past due but not impaired		ü
Credit quality of all loans and advances	ü	
Credit quality of loans neither past due nor impaired		ü
Interest foregone on non-performing lending	ü	ü

ANALYSIS OF IMPAIRMENT AND PROVISION STATUS

31 December 2017 and earlier years

The table below shows separately those loans that are (i) neither past due nor impaired, (ii) past due but not impaired, (iii) impaired, but not requiring a provision and (iv) impaired with a provision.

(audited)	Loans and advances to banks £m	**Loans and advances to customers** Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2017						
Neither past due nor impaired	6,577	295,765	48,897	116,396	461,058	31,590
Past due but not impaired	6	5,934	585	336	6,855	–
Impaired – no provision required	28	640	306	700	1,646	–
– provision held	–	3,529	1,053	1,613	6,195	–
Gross	6,611	305,868	50,841	119,045	475,754	31,590
31 December 2016						
Neither past due nor impaired	26,888	296,303	39,478	109,364	445,145	33,079
Past due but not impaired	14	7,340	386	305	8,031	–
Impaired – no provision required	–	784	392	689	1,865	–
– provision held	–	3,536	1,038	2,056	6,630	–
Gross	26,902	307,963	41,294	112,414	461,671	33,079
31 December 2015						
Neither past due nor impaired	25,006	302,063	38,886	100,001	440,950	33,174
Past due but not impaired	111	8,233	393	463	9,089	–
Impaired – no provision required	–	732	690	1,092	2,514	–
– provision held	–	3,269	911	2,896	7,076	–
Gross	25,117	314,297	40,880	104,452	459,629	33,174
31 December 2014						
Neither past due nor impaired	26,003	320,324	37,886	106,768	464,978	36,725
Past due but not impaired	152	10,311	674	488	11,473	–
Impaired – no provision required	–	578	938	847	2,363	–
– provision held	–	3,766	1,109	7,070	11,945	–
Gross	26,155	334,979	40,607	115,173	490,759	36,725

The analysis of lending between retail and commercial has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within commercial are exposures to corporate customers and other large institutions.

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31 December 2018

The table below analyses the Group's loans and advances to customers and banks that are considered to have experienced a significant increase in credit risk, but are not credit-impaired, according to the number of days that have elapsed since the last payment received by the Group was due from the borrower; the analysis of lending has been prepared based on the division in which the asset is held.

	Loans and advances to banks £m	Loans and advances to customers Retail – mortgages £m	Retail – other £m	Commercial £m	Other £m	Total £m
31 December 2018						
Up to date	3	10,118	4,387	6,020	10	20,535
1-30 days past due	–	1,955	486	455	–	2,896
Over 30 days past due	–	1,581	214	117	2	1,914
Total	3	13,654	5,087	6,592	12	25,345

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

31 December 2017 and earlier years

The loans that are past due but not impaired are analysed in the table below according to the number of days that have elapsed since the last payment received by the Group was due from the borrower. The analysis of lending between retail and commercial has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within commercial are exposures to corporate customers and other large institutions.

(audited)	Loans and advances to banks £m	**Loans and advances to customers** Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2017						

0-30 days	6	3,057	458	246	3,761	–
30-60 days	–	1,115	111	10	1,236	–
60-90 days	–	785	3	13	801	–
90-180 days	–	977	3	8	988	–
Over 180 days	–	–	10	59	69	–
Total	6	5,934	585	336	6,855	–
31 December 2016						
0-30 days	14	3,547	285	157	3,989	–
30-60 days	–	1,573	75	37	1,685	–
60-90 days	–	985	2	74	1,061	–
90-180 days	–	1,235	6	14	1,255	–
Over 180 days	–	–	18	23	41	–
Total	14	7,340	386	305	8,031	–
31 December 2015						
0-30 days	111	4,066	276	248	4,590	–
30-60 days	–	1,732	81	100	1,913	–
60-90 days	–	1,065	9	52	1,126	–
90-180 days	–	1,370	8	19	1,397	–
Over 180 days	–	–	19	44	63	–
Total	111	8,233	393	463	9,089	–
31 December 2014						
0-30 days	152	4,854	453	198	5,505	–
30-60 days	–	2,309	110	51	2,470	–
60-90 days	–	1,427	90	139	1,656	–
90-180 days	–	1,721	5	38	1,764	–
Over 180 days	–	–	16	62	78	–
Total	152	10,311	674	488	11,473	–

A financial asset is “past due” if a counterparty has an amount outstanding beyond its contractual due date.

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POTENTIAL PROBLEM LOANS

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

31 December 2018

IFRS 7 requires the disclosure of information about the credit quality of loans and advances. The Group's disclosures analyse its loans between those that the Group believes are of good quality, satisfactory quality, lower quality and those that are below standard but not credit-impaired. The below standard but not credit-impaired balances represent potential problem loans; the analysis of lending has been prepared based on the division in which the asset is held.

	Loans and advances to banks	Loans and advances to customers				
		Retail – mortgages	Retail – other	Commercial	Other	Total
	£m	£m	£m	£m	£m	£m
31 December 2018						
Good quality	6,180	268,524	47,051	65,189	44,375	425,139
Satisfactory quality	105	1,766	3,720	28,922	6	34,414
Lower quality	–	262	357	4,429	–	5,048
Below standard, but not credit-impaired	–	899	1,322	54	–	2,275
Total	6,285	271,451	52,450	98,594	44,381	466,876

31 December 2017 and earlier years

IFRS 7 required the disclosure of information about the credit quality of loans and advances that were neither past due nor impaired. The Group's disclosures analyse these loans between those that the Group believed were of good quality, satisfactory quality, lower quality and those that were below standard but not impaired. The below standard but not impaired balances represented potential problem loans. The analysis of lending between retail and commercial has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within commercial are exposures to corporate customers and other large institutions.

Loans and advances designated

	Loans and advances	**Loans and advances to customers**				at fair value through
		Retail –	Retail –			
	to banks	mortgages	other	Commercial	Total	profit or loss
(audited)	£m	£m	£m	£m	£m	£m
31 December 2017						
Good quality	6,351	294,748	43,145	81,121		31,548
Satisfactory quality	198	790	4,770	30,154		42
Lower quality	28	32	286	4,807		–
Below standard, but not impaired	–	195	696	314		–
Total	6,577	295,765	48,897	116,396	461,058	31,590
31 December 2016						
Good quality	26,745	295,286	34,195	72,083		33,049
Satisfactory quality	87	814	4,479	30,433		30
Lower quality	3	39	387	6,433		–
Below standard, but not impaired	53	164	417	415		–
Total	26,888	296,303	39,478	109,364	445,145	33,079
31 December 2015						
Good quality	24,670	301,403	33,589	63,453		33,156
Satisfactory quality	311	527	4,448	28,899		15
Lower quality	4	27	476	7,210		3
Below standard, but not impaired	21	106	373	439		–
Total	25,006	302,063	38,886	100,001	440,950	33,174
31 December 2014						
Good quality	25,654	318,967	30,993	65,106		36,482
Satisfactory quality	263	1,159	5,675	28,800		238
Lower quality	49	72	623	11,204		5
Below standard, but not impaired	37	126	595	1,658		–
Total	26,003	320,324	37,886	106,768	464,978	36,725

For further details see note 52 on page F-91.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

	2018 £m
Interest income that would have been recognised under original contract terms	324
Interest income included in profit	(227)
Interest foregone	97

TROUBLED DEBT RESTRUCTURINGS

The Company's accounting policy for loans that are renegotiated is set out in note 2(H) to the financial statements. In accordance with IFRS 9, an impairment provision is recognised on all loans; as a result, the Company has amended these disclosures in 2018. Loans modified by the Group during the year as a result of a customer's financial difficulties were credit-impaired at 31 December 2018 and are included within the forborne balances set out in the table below.

	Credit-impaired forborne loans and advances £m	Purchased or originated credit-impaired forborne loans and advances £m	Other forborne loans and advances £m	Total forborne loans and advances £m
At 31 December 2018				
Retail:				
Secured	642	4,241	1,206	6,089
Unsecured	200	–	235	435
UK Motor Finance	25	–	31	56
Total Retail	867	4,241	1,472	6,580
Commercial	2,978	–	894	3,872

	Total forborne loans	Total forborne loans	Total loans and	Impairment allowance as a % of

	and advances which are not impaired £m	and advances which are impaired £m	advances which are forborne £m	loans and advances which are forborne %
At 31 December 2017				
UK secured retail	1,291	137	1,428	4.3
UK unsecured retail	55	139	194	38.6
Consumer credit cards	105	190	295	36.0
Asset Finance UK Retail	15	19	34	36.6
Run off: Ireland secured retail	213	25	238	21.0
Commercial Banking	447	1,927	2,374	35.0
Run off: Corporate Real Estate, other Corporate and Specialist Finance	–	715	715	44.1
At 31 December 2016				
UK secured retail	1,879	217	2,096	4.7
UK unsecured retail	20	107	127	40.5
Consumer credit cards	93	119	212	29.0
Asset Finance UK Retail	55	62	117	27.0
Run off: Ireland secured retail	137	19	156	16.6
Commercial Banking	466	2,197	2,663	31.1
Run off: Corporate Real Estate, other Corporate and Specialist Finance	3	995	998	51.1
At 31 December 2015				
UK secured retail	2,929	173	3,102	4.2
UK unsecured retail	28	119	147	40.0
Consumer credit cards	105	120	225	26.8
Asset Finance UK Retail	49	51	100	25.5
Run off: Ireland secured retail	143	26	169	13.3
Commercial Banking	986	2,543	3,529	30.9
Run off: Corporate Real Estate, other Corporate and Specialist Finance	9	1,771	1,780	52.5
Run-off Ireland: Commercial real estate and corporate	32	5	37	0.0

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	Total forborne loans and advances which are not impaired £m	Total forborne loans and advances which are impaired £m	Total loans and advances which are forborne £m	Impairment allowance as a % of loans and advances which are forborne %
At 31 December 2014				
UK secured retail	4,128	266	4,394	3.5
UK unsecured retail	23	139	162	39.4
Consumer credit cards	94	140	234	29.1
Asset Finance UK Retail	56	53	109	20.5
Run off: Ireland secured retail	239	41	280	12.7
Commercial Banking	1,896	3,241	5,137	31.0
Run off: Corporate Real Estate, other Corporate and Specialist Finance	86	1,912	1,998	58.3
Run-off Ireland: Commercial real estate and corporate	384	3,052	3,436	72.2

The Group assesses whether a loan benefiting from a UK Government-sponsored programme is impaired or a troubled debt restructuring using the same accounting policies and practices as it does for loans not benefiting from such a programme.

Further information on the schemes operated by the Group to assist borrowers who are experiencing financial stress and on the Group’s forborne loans is set out on pages 53 to 54 and pages 60 to 64.

ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES

In most circumstances in the US, title to property securing residential real estate transfers to the lender upon foreclosure. The loan is written off and the property acquired in this way is reported in a separate balance sheet category with any recoveries recorded as an offset to the provision for loan losses recorded in the year. Upon sale of the acquired property, gains or losses are recorded in the income statement as a gain or loss on acquired property.

In the UK, although a bank is entitled to enforce a first charge on a property held as security, it typically does so only to the extent of enforcing its power of sale. In accordance with IFRS and industry practice, Lloyds Banking Group usually takes control of a property held as collateral on a loan at repossession without transfer of title. Loans subject to repossession continue to be reported as loans in the balance sheet. The Group’s gains or losses on sale of the acquired property are recorded within the provision for loan losses during the reporting period.

The difference in practices has no effect on net income reported in the UK compared to that reported in the US but it does result in a difference in classification of losses and recoveries in the income statement. It also has the effect of causing UK banks to report an increased level of non-performing loans compared with US banks.

In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

CROSS BORDER OUTSTANDINGS

The business of Lloyds Banking Group involves exposures in non-local currencies. These cross border outstandings comprise loans (including accrued interest), acceptances, interest-bearing deposits with other banks, other interest-bearing investments and any other monetary assets which are denominated in non-local currency. The following table analyses, by type of borrower, foreign outstandings which individually represent in excess of 1 per cent of Lloyds Banking Group's total assets.

	% of assets	Total £m	Governments and official institutions £m	Banks and other financial institutions £m	Commercial, industrial and other £m
At 31 December 2018:					
United States of America	1.6	12,502	4,045	5,091	3,366
At 31 December 2017:					
United States of America	1.6	12,963	6,760	3,205	2,998
At 31 December 2016:					
United States of America	1.6	13,224	7,564	1,718	3,942

At 31 December 2018, United States of America had commitments of £1,212 million.

At 31 December 2018, no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2017, no countries had cross border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2016, no countries had cross border outstandings of between 0.75 per cent and 1 per cent of assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

REGULATORY AND LEGAL RISK

DEFINITION

Regulatory and legal risk is defined as the risk that the Group is exposed to financial loss, fines, censure, or legal or enforcement action; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including codes of practice which could have legal implications), regulations, codes of conduct, legal obligations, or a failure to adequately manage actual or threatened litigation, including criminal proceedings.

EXPOSURES

Whilst the Group has a zero risk appetite for material regulatory breaches or material legal incidents, the Group remains exposed to them, driven by significant ongoing and new legislation, regulation and court proceedings in the UK and overseas which in each case needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group.

MEASUREMENT

Regulatory and legal risks are measured against a defined risk appetite metric, which is an assessment of material regulatory breaches and material legal incidents.

MITIGATION

The Group undertakes a range of key mitigating actions to manage regulatory and legal risk. These include the following:

–The Board establishes a Group-wide risk appetite and metric for regulatory and legal risk.

- Group policies and procedures set out the principles and key controls that should apply across the business which are aligned to the Group risk appetite. Mandated policies and processes require appropriate control frameworks, management information, standards and colleague training to be implemented to identify and manage regulatory and legal risk.
- Business units identify, assess and implement policy and regulatory requirements and establish local controls, processes, procedures and resources to ensure appropriate governance and compliance.
- Business units regularly produce management information to assist in the identification of issues and test management controls are working effectively.
- Risk and Legal provide oversight, proactive support and constructive challenge to the business in identifying and managing regulatory and legal issues.
- Risk conducts thematic reviews of regulatory compliance and provides oversight of regulatory compliance assessments across businesses and divisions where appropriate.
- Business units, with the support of divisional and Group-level bodies, conduct ongoing horizon scanning to identify changes in regulatory and legal requirements.
- The Group engages with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations, ensuring programmes are established to deliver new regulation and legislation.

MONITORING

Material risks are managed through the relevant divisional level committees, with review and escalation through Group level committees where appropriate, including the escalation of any material regulatory breaches or material legal incidents.

CONDUCT RISK

DEFINITION

The risk of customer detriment due to poor design, distribution and execution of products and services or other activities which could undermine the integrity of the market or distort competition, leading to unfair customer outcomes, regulatory censure and financial and reputational loss.

EXPOSURES

The Group faces significant conduct risks, which affect all aspects of the Group's operations and all types of customers.

Conduct risks can impact directly or indirectly on the Group's customers and can materialise from a number of areas across the Group, including: business and strategic planning that does not sufficiently consider customer needs; ineffective management and monitoring of products and their distribution (including the sales process); unclear, unfair, misleading or untimely customer communications; a culture that is not sufficiently customer-centric; poor governance of colleagues' incentives and rewards and approval of schemes which drive unfair customer outcomes; ineffective management and oversight of legacy conduct issues; ineffective management of customers' complaints or claims; and outsourcing of customer service and product delivery via third-parties that do not have the same level of control, oversight and culture as the Group. The Group is also exposed to the risk of engaging in or failing to manage conduct which could constitute market abuse, undermine the integrity of a market in which it is active, distort competition or create conflicts of interest.

There is a high level of scrutiny regarding financial institutions' treatment of customers, including those in vulnerable circumstances, from regulatory bodies, the media, politicians and consumer groups.

There continues to be a significant focus on market misconduct, resulting from previous issues relating to London Inter-bank Offered Rate (LIBOR) and foreign exchange (FX).

Due to the level of enhanced focus relating to conduct, there is a risk that certain aspects of the Group's current or legacy business may be determined by the Financial Conduct Authority, other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or in a manner that fails to deliver fair and reasonable customer treatment.

MEASUREMENT

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable Conduct Risk Appetite Metrics (CRAMs) and tolerances that indicate where it may be operating outside its conduct risk appetite. These include Board-level conduct risk metrics covering an assessment of overall CRAMs performance, out of appetite CRAMs, Financial Ombudsman Service (FoS) change rates and complaints.

CRAMs have been designed for services and product families offered by the Group and are measured by a consistent set of common metrics. These contain a range of product design, sales and process metrics to provide a more holistic view of conduct risks; some products also have a suite of additional bespoke metrics.

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Each of the tolerances for the metrics are agreed for the individual product or service and are regularly tracked. At a consolidated level these metrics are part of the Board risk appetite. The Group continues to evolve its approach to measurements supporting customer vulnerability, process delivery and customer journeys.

MITIGATION

The Group takes a range of mitigating actions with respect to conduct risk. The Group's ongoing commitment to good customer outcomes sets the tone from the top and supports the development of the right customer-centric culture – strengthening links between actions to support conduct, culture and customer and enabling more effective control management. Actions to enable good conduct include:

– Conduct risk appetite established at Group and business area level, with metrics included in the Group risk appetite to ensure ongoing focus.

– Conduct policies and procedures in place to ensure appropriate controls and processes that deliver fair customer outcomes.

– Customer needs explicitly considered within business and product level planning and strategy, through divisional customer plans, with integral conduct lens, reviewed and challenged by Group Customer First Committee (GCFC).

– Cultural transformation, supported by strong direction and tone from senior executives and the Board. This is underpinned by the Group's values, behaviours and code of responsibility, to deliver the best bank for customers.

– Continued embedding of the customer vulnerability framework. The Customer Vulnerability Cross Divisional Committee continues to operate at a senior level to prioritise change, drive implementation and ensure consistency across the Group. Significant partnership with Macmillan to support customers with cancer continues, alongside ongoing activities to support all vulnerable customers, including those experiencing financial and domestic abuse.

– Continued embedding and evolving of the Group's customer journey strategy and framework to support the Group's focus on conduct from an end-to-end customer perspective.

– Enhanced product governance framework to ensure products continue to offer customers fair value, and consistently meet their needs throughout their product life cycle; reviewed and challenged by Group Product Governance Committee (GPGC).

– Enhanced complaints management through effectively responding to, and learning from, root causes of complaint volumes and FoS change rates.

– Review and oversight of thematic conduct agenda items at GPGC, ensuring holistic consideration of key Group-wide conduct risks.

– Enhanced recruitment and training, with a focus on how the Group manages colleagues' performance with clearer customer accountabilities.

– Ongoing engagement with third-parties involved in serving the Group's customers to ensure consistent delivery.

– Monitoring and testing of customer outcomes to ensure the Group delivers fair outcomes for customers whilst making continuous improvements to products, services and processes.

– Continued focus on market conduct through training and enhancements of procedures and controls, governed by the Market Steering Committee which also provides read-across for the Group on industry issues.

– Implementation of enhanced change delivery methodology to enable prioritisation and delivery of initiatives to address conduct challenges.

– Focus on proactive identification and mitigation of conduct risk in the Group Strategic Review 3.

– Active engagement with regulatory bodies and other stakeholders to develop understanding of concerns related to customer treatment, effective competition and market integrity, to ensure that the Group's strategic conduct focus continues to meet evolving stakeholder expectations.

MONITORING

Monitoring and reporting is undertaken at Board, Group and business area committees. As part of the reporting of CRAMs, a robust outcomes testing regime is in place to determine whether the Group is delivering fair outcomes for customers.

GCFC acts as the guardian of customer experience and has responsibility for monitoring and reviewing plans and actions to improve it, including challenging divisions to make changes based on key learnings to support the delivery of the Group's vision and foster a customer-centric culture.

OPERATIONAL RISK

DEFINITION

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, which can lead to adverse customer impact, reputational damage or financial loss.

EXPOSURES

The principal operational risks to the Group which could result in customer detriment, unfair customer outcomes, financial loss, disruption and/or reputational damage are:

- A cyber-attack;
- Change and execution risk in delivering the Group’s change agenda;
- Failure in IT systems, due to volume of change, and/or aged infrastructure;
- Failure to protect and manage the Group’s and customers’ data;
- Internal and/or external fraud or financial crime;
- Failure to ensure compliance with increasingly complex and detailed regulation including anti-money laundering, anti-bribery, counter-terrorist financing, and financial sanctions and prohibitions laws and regulations; and
- Operational resilience and damage to physical assets including: terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events.

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

MEASUREMENT

Operational risk is managed across the Group through an operational risk framework and operational risk policies. The operational risk framework includes a risk and control self-assessment process, risk impact likelihood matrix, key risk and control indicators, risk appetite, a robust operational event management and escalation process, scenario analysis and an operational losses process.

Table 1.26 below shows high level loss and event trends for the Group using Basel II categories. Based on data captured on the Group’s Operational Risk System, in 2018 the highest frequency of events occurred in external fraud (59.83 per cent) and execution, delivery and process management (25.52 per cent). Clients, products and business practices accounted for 63.18 per cent of losses by value, driven by legacy issues where impacts materialised in 2018 (excluding PPI).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.26: **Operational risk events by risk category (losses greater than or equal to £10,000), excluding PPI[1]**

	% of total volume		% of total losses	
	2018	2017	**2018**	2017
Business disruption and system failures	**1.10**	1.43	**2.80**	1.31
Clients, products and business practices	**11.61**	10.84	**63.18**	86.23
Damage to physical assets	**1.47**	1.78	**0.20**	0.17
Employee practices and workplace safety	**–**	0.05	**–**	0.06
Execution, delivery and process management	**25.52**	24.26	**30.03**	8.91
External fraud	**59.83**	61.29	**3.68**	3.38
Internal fraud	**0.47**	0.35	**0.11**	(0.06)
Total	**100.00**	100.00	**100.00**	100.00

1 2017 breakdowns have been restated to reflect a number of events that have been reclassified following an internal review.

Operational risk losses and scenario analysis is used to inform the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its minimum (Pillar I) operational risk capital requirements using The Standardised Approach (TSA). Pillar II is calculated using internal and external loss data and extreme but plausible scenarios that may occur in the next 12 months.

MITIGATION

The Group’s strategic review considers the changing risk management requirements, adapting the change delivery model to be more agile and develop the people skills and capabilities needed to be a ‘Bank of the Future’. The Group continues to review and invest in its control environment to ensure it addresses the inherent risks faced. Risks are reported and discussed at local governance forums and escalated to executive management and Board as appropriate to ensure the correct level of visibility and engagement. The Group employs a range of risk management strategies, including: avoidance, mitigation, transfer (including insurance) and acceptance. Where there is a reliance on third-party suppliers to provide services, the Group’s sourcing policy ensures that outsourcing initiatives follow a defined process including due diligence, risk evaluation and ongoing assurance.

Mitigating actions to the principal operational risks are:

The threat landscape associated with cyber risk continues to evolve and there is significant regulatory attention on this subject. The Board has defined a cyber risk appetite and continues to invest heavily to protect the Group from malicious cyber-attacks. Most recent investment has focused on improving the Group's approach to identity and access management, improving capability to detect and respond to cyber-attacks and improved ability to manage vulnerabilities across the estate.

The Group acknowledges the challenges faced with delivering new strategic initiatives and programmes alongside the extensive agenda of regulatory and legal changes whilst enhancing systems and controls. To address this, impacts of change are assessed in terms of the ability of the business to execute effectively and the potential impact on its risk profile. Key elements are monitored, including identifying resources and skills required to deliver change, critical dependencies and change readiness, while controls are also put in place to manage change activity and are monitored in line with the Group Change Policy. Execution and change risks and controls are reported through Group Transformation governance up to Board Risk Committee, and are recorded on key risk systems to allow for consolidation and aggregation. To supplement this, the Group takes a risk-based approach to change oversight across the three lines of defence, encompassing delivery assurance, risk oversight and audit reviews focused on a combination of specific change activity and broad overarching themes.

The Group continues to optimise its approach to IT and operational resilience by investing in technology improvements and enhancing the resilience of systems that support the Group's critical business processes, primarily through the Technology Resilience Programme, with independent verification of progress on an annual basis. The Board recognises the role that resilient technology plays in achieving the Group's strategy of becoming the best bank for customers and in maintaining banking services across the wider industry. As such, the Board dedicates considerable time and focus to this subject at both the Board and the Board Risk Committee, and continues to sponsor key investment programmes that enhance resilience.

The Group is making a significant investment to improve data, including the security of data and oversight of third-parties. The Group's strategy is to introduce advanced data management practices, based on Group-wide standards, data-first culture and modern enterprise data platforms, supported by a simplified modern IT architecture.

The Group adopts a risk-based approach to mitigate the internal and external fraud risks it faces, reflecting the current and emerging fraud risks within the market. Fraud risk appetite metrics have been defined, holistically covering the impacts of fraud in terms of losses to the Group, costs of fraud systems and operations, and customer experience of actual and attempted fraud. Oversight of the appropriateness and performance of these metrics is undertaken regularly through business area and Group-level committees. This approach drives a continual programme of prioritised enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Group-wide policies and operational control frameworks are maintained and designed to provide customer confidence, protect the Group's commercial interests and reputation, comply with legal requirements and meet regulatory expectations. The Group's fraud awareness programme remains a key component of its fraud control environment, and awareness of fraud risk is supported by mandatory training for all colleagues. The Group also plays an active role with other financial institutions, industry bodies, and enforcement agencies in identifying and combatting fraud.

The Group has adopted policies and procedures designed to detect and prevent the use of its banking network for money laundering, terrorist financing, bribery, tax evasion, human trafficking, and modern-day slavery, and activities prohibited by legal and regulatory sanctions. Against a background of increasingly complex and detailed laws and regulations, and of increased criminal and terrorist activity, the Group regularly reviews and assesses its policies, procedures and organisational arrangements to keep them current, effective and consistent across markets and jurisdictions. The Group requires mandatory training on these topics for all employees. Specifically, the anti-money laundering procedures include 'know-your-customer' requirements, transaction monitoring technologies, reporting of suspicions of money laundering or terrorist financing to the applicable regulatory authorities, and interaction between the Group's Financial Intelligence Unit and external agencies and other financial institutions. The Anti-Bribery Policy prohibits the payment, offer, acceptance or request of a bribe, including ‘facilitation payments’ by any employee or agent and provides a confidential reporting service for anonymous reporting of suspected or actual bribery activity. The Sanctions and the Related Prohibitions Policy sets out a framework of controls for compliance with legal and regulatory sanctions.

The Group has increased its focus on operational resilience and has updated its operational resilience strategy to reflect changing priorities of both customers and regulators. At the core of its approach to operational resilience are the Group’s Critical business processes which drive all activity, including further mapping of the processes to identify any additional resilience requirements such as impact tolerances in the event of a service outage. The Group continues to develop playbooks that address a range of interruptions from internal and external threats and tests these through scenario-based testing and exercising.

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MONITORING

Monitoring and reporting of operational risk is undertaken at Board, Group and divisional risk committees. Each committee monitors key risks, control effectiveness, key risk and control indicators, events, operational losses, risk appetite metrics and the results of independent testing conducted by Risk and/or Internal Audit.

The Group maintains a formal approach to operational risk event escalation, whereby material events are identified, captured and escalated. Root causes of events are determined, where possible, and action plans put in place to ensure an optimum level of control to keep customers and the business safe, reduce costs, and improve efficiency.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

PEOPLE RISK

DEFINITION

The risk that the Group fails to provide an appropriate colleague and customer-centric culture, supported by robust reward and wellbeing policies and processes; effective leadership to manage colleague resources; effective talent and succession management; and robust control to ensure all colleague-related requirements are met.

EXPOSURES

The Group's management of material people risks is critical to its capacity to deliver against its strategic objectives and to be the best bank for customers. The Group is exposed to the following key people risks:

- Maintaining organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change;

- Senior Managers and Certification Regime (SM&CR) and additional regulatory constraints on remuneration structures may impact the Group's ability to attract and retain talent;

- The increasing digitisation of the business is changing the capability mix required and may impact the Group's ability to attract and retain talent;

- The increasing demands on colleagues and consequential impact colleague wellbeing may impact on the Group's ability to enhance colleague skills to achieve capability uplift for a digital era; and

- Colleague engagement may continue to be challenged by ongoing media attention on banking sector culture, conduct and ethical considerations.

MEASUREMENT

People risk is measured through a series of quantitative and qualitative indicators, aligned to key sources of people risk for the Group such as succession, retention, colleague engagement, wellbeing and performance management. In addition to risk appetite measures and limits, people risks and controls are monitored on a monthly basis via the Group's risk governance framework and reporting structures.

MITIGATION

The Group takes many mitigating actions with respect to people risk. Key areas of focus include:

- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;

- Continued focus on the Group's culture by developing and delivering initiatives that reinforce the appropriate behaviours which generate the best possible long-term outcomes for customers and colleagues;

- Managing organisational capability and capacity through divisional people strategies to ensure there are the right skills and resources to meet the Group's customers' needs and deliver the Group's strategic plan;

- Maintain effective remuneration arrangements to ensure they promote an appropriate culture and colleague behaviours that meet customer needs and regulatory expectations;

- Ensuring colleague wellbeing strategies and support are in place to meet colleague needs, and that the skills and capability growth required to build a workforce for the 'Bank of the Future' are achieved;

- Ensuring compliance with legal and regulatory requirements related to SM&CR, embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities; and

–Ongoing consultation with the Group’s recognised unions on changes which impact their members.

MONITORING

People risks from across the Group are monitored and reported through Board and Group Governance Committees in accordance with the Group’s Risk Management Framework. Risk exposures are discussed monthly via the Group People Risk Committee with upwards reporting to Group Risk and Executive Committees. In addition, oversight, challenge and reporting are completed at Risk division level to assess the effectiveness of controls, recommending follow up remedial action if required. All material people risk events are escalated in accordance with the formal Group Operational Risk Policy and People Policies to the respective divisional Managing Directors and the Group Director, Conduct, Compliance and Operational Risk.

INSURANCE UNDERWRITING RISK

DEFINITION

Insurance underwriting risk is defined as the risk of adverse developments in longevity, mortality, persistency, General Insurance underwriting and policyholder behaviour, leading to reductions in earnings and/or value.

EXPOSURES

The major source of insurance underwriting risk within the Group is the Insurance business.

Longevity and persistency are key risks within the life and pensions business. Longevity risk arises from the annuity portfolios where policyholders’ future cash flows are guaranteed at retirement and increases in life expectancy, beyond current assumptions, will increase the cost of annuities. Longevity risk exposures are expected to increase with the Insurance business growth in the annuity market. Persistency assumptions are set to give a best estimate; however customer behaviour may result in increased cancellations or cessation of contributions.

Property insurance risk is a key risk within the General Insurance business, through Home Insurance. Exposures can arise, for example, in extreme weather conditions such as flooding, when property damage claims are higher than expected.

The Group's defined benefit pension schemes also expose the Group to longevity risk. For further information please refer to the defined benefit pension schemes component of the market risk section and note 35 to the financial statements.

MEASUREMENT

Insurance underwriting risks are measured using a variety of techniques including stress, reverse stress and scenario testing, as well as stochastic modelling. Current and potential future insurance underwriting risk exposures are assessed and aggregated on a range of stresses including risk measures based on 1-in-200 year stresses for Insurance's regulatory capital assessments and other supporting measures where appropriate, including those set out in note 32 to the financial statements.

MITIGATION

Insurance underwriting risk in the Insurance business is mitigated in a number of ways:

- Strategic decisions made consider the maintenance of the current well-diversified portfolio of insurance risks;
- Processes for underwriting, claims management, pricing and product design seek to control exposure. Experts in demographic risk (for example longevity) support the propositions;
- General Insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements;
- Longevity risk transfer and hedging solutions are considered on a regular basis and since 2017 Insurance has reinsured £2.7 billion of annuitant longevity;
- Exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite.

MONITORING

Insurance underwriting risks in the Insurance business are monitored by Insurance senior executive committees and ultimately the Insurance Board. Significant risks from the Insurance business and the defined benefit pension schemes are reviewed by the Group Executive and Group Risk Committees and/or Board.

Insurance underwriting risk exposures within the Insurance business are monitored against risk appetite. The Insurance business monitors experiences against expectations, for example business volumes and mix, claims and persistency experience. The effectiveness of controls put in place to manage insurance underwriting risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken.

CAPITAL RISK

DEFINITION

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

EXPOSURES

A capital risk exposure arises when the Group has insufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. This could arise due to a depletion of the Group's capital resources as a result of the crystallisation of any of the risks to which it is exposed. Alternatively a shortage of capital could arise from an increase in the amount of capital that needs to be held either at Group level or at regulated entity or sub-group levels under the Group's post ring-fence structure. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures while optimising value for shareholders.

MEASUREMENT

The Group measures the amount of capital it requires and holds through applying the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation

Authority (PRA) and supplemented through additional regulation under the PRA Rulebook.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of aggregate risk-weighted assets. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital and at least 6 per cent of risk-weighted assets are required to be covered by tier 1 capital. These minimum Pillar 1 requirements are supplemented by additional minimum requirements under Pillar 2A of the regulatory framework, the aggregate of which is referred to as the Group's Total Capital Requirement (TCR), and a number of regulatory capital buffers as described below.

Additional minimum requirements under Pillar 2A are set by the PRA as a firm-specific Individual Capital Requirement (ICR) reflecting a point in time estimate, which may change over time, of the minimum amount of capital that is needed by the bank to cover risks that are not fully covered by Pillar 1, such as credit concentration and operational risk, and those risks not covered at all by Pillar 1, such as pensions and interest rate risk in the banking book (IRRBB).

The Group is also required to maintain a number of regulatory capital buffers, which are required to be met with CET1 capital.

Systemic buffers are designed to hold systemically important banks to higher capital standards, so that they can withstand a greater level of stress before requiring resolution.

– Although the Group is not currently classified as a global systemically important institution (G-SII) under the Capital Requirements Directive, it has been classified as an 'other' systemically important institution (O-SII) by the PRA. The O-SII buffer is set to zero in the UK.

– The systemic risk buffer (SRB) will come into force for UK ring-fenced banks during 2019, with the PRA expected to announce both the SRB rate and date of application for the Group's Ring-Fenced Bank (RFB) sub-group in the first half of 2019. The size of buffer applied to the RFB sub-group will be dependent upon its total assets. Although the SRB will apply at a sub-consolidated level within the Group's structure, the PRA has indicated that they will include in the Group's PRA Buffer an amount equivalent to the RFB sub-group's SRB. The amount included in the PRA Buffer is expected to be lower as a percentage of Group risk-weighted assets reflecting the assets of the Group that are not held in the RFB sub-group and for which the SRB will not apply.

The capital conservation buffer (CCB) is a standard buffer of 2.5 per cent of risk-weighted assets designed to provide for losses in the event of stress. The CCB has been phased in over a number of years – during 2018 it was 1.875 per cent and it increased to the full 2.5 per cent on 1 January 2019.

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The countercyclical capital buffer (CCYB) is time-varying and is designed to require banks to hold additional capital to remove or reduce the build-up of systemic risk in times of credit boom, providing additional loss absorbing capacity and acting as an incentive for banks to constrain further credit growth. The amount of the buffer is determined by reference to buffer rates set by the FPC for the individual countries where the Group has relevant credit exposures. The CCYB rate for the UK is currently set at 1.0 per cent. The FPC regularly considers the adequacy of the UK CCYB rate in light of the evolution of the overall risk environment. As at 31 December 2018 non-zero buffer rates also currently apply for Norway, Sweden, Hong Kong, Iceland, Slovakia, Czech Republic, and Lithuania. During 2019 France, Bulgaria, Denmark and Ireland will implement non-zero buffer rates. The Group's overall countercyclical capital buffer at 31 December 2018 was 0.9 per cent of risk-weighted assets, having increased significantly during the year (from 0.002 per cent at 31 December 2017) as a result of the increase in the UK rate from nil to 1.0 per cent, the Group's relevant credit exposures being predominantly UK based.

As part of the capital planning process, forecast capital positions are subjected to extensive internal stress testing to determine the adequacy of the Group's capital resources against the minimum requirements, including the ICR. The PRA considers outputs from both the Group's internal stress tests and the annual Bank of England stress test, in conjunction with the Group's other regulatory capital buffers, as part of the process for informing the setting of a bank-specific capital buffer for the Group, known as the PRA Buffer. The PRA requires the PRA Buffer to remain confidential between the Group and the PRA.

All buffers are required to be met with CET1 capital. A breach of the PRA buffer would trigger a dialogue between the Group and the PRA to agree what action is required whereas a breach of the CRD IV combined buffer (all regulatory buffers excluding the PRA buffer) would give rise to automatic constraints upon any discretionary capital distributions by the Group.

In addition to the risk-based capital framework outlined above, the Group is also subject to minimum capital requirements under the UK Leverage Ratio Framework. The leverage ratio is calculated by dividing fully loaded tier 1 capital resources by a defined measure of on-balance sheet assets and off-balance sheet items.

The minimum leverage ratio requirement under the UK Leverage Ratio Framework is 3.25 per cent. This is supplemented by a time-varying countercyclical leverage buffer (CCLB) which is determined by multiplying the leverage exposure measure by 35 per cent of the countercyclical capital buffer (CCYB) rate. As at 31 December 2018 the CCLB was 0.3 per cent (31 December 2017: nil). An additional leverage ratio buffer (ALRB) will apply from 2019 to the Group's ring-fenced bank (RFB) sub-group, to be determined by multiplying the RFB leverage exposure measure by 35 per cent of the SRB. An equivalent amount of capital, referred to as the Leverage Ratio Group Add-on, will be required to be held at Group level under the UK leverage framework to cover the RFB's additional leverage ratio buffer.

At least 75 per cent of the 3.25 per cent minimum leverage ratio requirement and the entirety of any buffers that may apply must be met by CET1 capital.

The leverage ratio framework does not currently give rise to higher capital requirements for the Group than the risk-based capital framework.

MITIGATION

The Group has a capital management framework including policies and procedures that are designed to ensure that it operates within its risk appetite, uses its capital resources efficiently and continues to comply with regulatory requirements.

The Group is able to accumulate additional capital through the retention of profits over time, which can be enhanced through cutting costs and reducing or cancelling dividend payments and share buybacks, by raising new equity via, for example, a rights issue or debt exchange and by raising additional tier 1 or tier 2 capital through issuing tier 1 instruments or subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demand for capital through management actions including adjusting its lending strategy, risk hedging strategies and through business disposals.

Additional measures to manage the Group's capital position include seeking to optimise the generation of capital demand within the Group's businesses to strike an appropriate balance of capital held within the Group's ring-fenced bank (RFB) sub-group and non-ring-fenced insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises.

MONITORING

Capital is actively managed and monitoring capital ratios is a key factor in the Group's planning processes and stress testing, which separately cover the RFB sub-group and key individual banking entities. Multi-year forecasts of the Group's capital position, based upon the Group's operating plan, are produced at least annually to inform the Group's capital plan whilst shorter term forecasts are more frequently undertaken to understand and respond to variations of the Group's actual performance against the plan. The capital plans are tested for capital adequacy using a range of stress scenarios covering adverse economic conditions as well as other adverse factors that could impact the Group and the Group maintains a recovery plan which sets out a range of potential mitigating actions that could be taken in response to a stress.

The capital plans also consider the impact of IFRS 9 which has the potential to increase bank capital volatility. Under stress this is primarily a result of provisioning for assets that are not in default at an earlier stage than would have been the case under IAS 39. In addition it currently remains unclear as to how the IFRS 9 requirement to reflect the outcome of multiple future economic scenarios within the calculation of the expected credit losses allowance (ECL) should be reflected in capital stress tests.

The Group notes that the UK regulatory authorities have previously announced, via the Financial Policy Committee (FPC), that the change in accounting standard will not change the cumulative losses banks incur during any given stress period (the losses will however be provided for at an earlier point in the stress) and that the FPC will take steps to ensure that the interaction of IFRS 9 accounting with its annual stress test does not result in de facto increases in capital requirements. In the short term the IFRS 9 transitional arrangements for capital, which the Group has adopted, will provide some stability in capital requirements against increased provisioning, measurement uncertainty and volatility, introduced in the accounting by the adoption of IFRS 9.

Regular reporting of actual and projected ratios for Group, the RFB sub-group and key legal entities, including those in stressed scenarios, is undertaken, including submissions to the Group Capital Risk Committee (GCRC), Group Financial Risk Committee (GFRC), Group Asset and Liability Committee (GALCO), Group Risk Committee (GRC), Board Risk Committee (BRC) and the Board. Capital policies and procedures are well established and subject to independent oversight.

The regulatory framework within which the Group operates continues to evolve and further detail on this will be provided in the Group's Pillar 3 report. The Group continues to monitor these developments very closely, analysing the potential capital impacts to ensure that, through organic capital

generation, the Group continues to maintain a strong capital position that exceeds both minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

Target capital ratios

The Board's view of the current level of CET1 capital required remains at around 13 per cent. In addition to this amount the Group intends to hold a management buffer of around 1 per cent to provide capacity for growth, meet regulatory requirements and cover uncertainties.

This takes into account, amongst other things:

– the minimum Pillar 1 CET1 capital requirement of 4.5 per cent of risk-weighted assets.

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- the Group's Pillar 2A ICR set by the PRA, reflecting their point in time estimate, which may change over time, of the amount of capital that is needed in relation to risks not covered by Pillar 1. During the year the PRA updated the Group's ICR representing a reduction from 5.4 per cent to 4.6 per cent of risk-weighted assets at 31 December 2018, of which 2.6 per cent must be met by CET1 capital. The requirement has increased to 4.7 per cent of risk-weighted assets, of which 2.7 per cent must be met by CET1 capital, from 1 January 2019 to reflect the commencement of the UK's ring-fencing regime.

- the capital conservation buffer (CCB) requirement of 1.875 per cent of risk-weighted assets, increasing to 2.5 per cent of risk-weighted assets from 1 January 2019.

- the Group's current countercyclical capital buffer (CCYB) requirement of 0.9 per cent of risk-weighted assets.

- the introduction of the SRB during 2019 for the RFB sub-group, which will require the Group to hold an equivalent monetary amount of capital.

- the Group's PRA Buffer, which the PRA sets after taking account of the results of the PRA stress tests and other information, as well as outputs from the Group's internal stress tests. The PRA requires the PRA Buffer itself to remain confidential between the Group and the PRA.

Dividend policy

The Group has established an ordinary dividend policy that is both progressive and sustainable, based on growing the ordinary dividend per share over time. The rate of growth of the ordinary dividend will be decided by the Board in light of the circumstances at the time.

The Board also gives due consideration to the return of surplus capital through the use of special dividends or share buybacks. Surplus capital represents capital over and above the amount management wish to retain to grow the business, meet regulatory requirements and cover uncertainties. The amount of required capital may vary from time to time depending on circumstances and by its nature there can be no guarantee that any return of surplus capital will be appropriate in future years.

The ability of the Group to pay a dividend is also subject to constraints including the availability of distributable reserves, legal and regulatory restrictions and the financial and operating performance of the entity.

Distributable reserves are determined as required by the Companies Act 2006 by reference to a company's individual financial statements. At 31 December 2018 Lloyds Banking Group plc ('the Company') had accumulated distributable reserves of approximately £8.5 billion. Substantially all of the Company's merger reserve is available for distribution under UK company law as a result of transactions undertaken to recapitalise the Company in 2009.

Lloyds Banking Group plc acts as a holding company which also issues capital and other securities to capitalise and fund the activities of the Group. The profitability of the holding company, and consequently its ability to sustain dividend payments, is therefore dependent upon the continued receipt of dividends from its main operating subsidiaries, including Lloyds Bank plc (the ring-fenced bank), Lloyds Bank Corporate Markets plc (the non-ring-fenced bank), LBG Equity Investments Limited (the non-ring-fenced investments business) and Scottish Widows Group Limited (the insurance business). A number of Group subsidiaries, principally those with banking and insurance activities, are subject to regulatory capital requirements which require minimum amounts of capital to be maintained relative to their size and risk. The principal operating subsidiary is Lloyds Bank plc which, at 31 December 2018, had a consolidated CET1 capital ratio of 14.9 per cent (31 December 2017: 15.8 per cent). The Group actively manages the capital of its subsidiaries, which includes monitoring the regulatory capital ratios for its banking and insurance subsidiaries and, on a consolidated basis, the RFB sub-group against approved internal risk appetite limits. The Group operates a formal capital management policy which requires all subsidiary entities to remit any surplus capital to their parent companies.

Minimum requirement for own funds and eligible liabilities (MREL)

The purpose of the minimum requirement for own funds and eligible liabilities (MREL) is to require firms to maintain sufficient equity and liabilities that are capable of credibly bearing losses in resolution. MREL can be satisfied by a combination of regulatory capital and certain unsecured debt resources (which must be subordinate to a firm's operating liabilities).

In November 2016 the Bank of England published a statement of policy on its approach for setting MREL in line with EU requirements.

Applying the Bank of England's MREL policy to minimum capital requirements from 1 January 2019, the Group's indicative MREL requirement, excluding regulatory capital buffers, is as follows:

– From 2020, 2 times Pillar 1 plus Pillar 2A, equivalent to 20.7 per cent of risk-weighted assets

– From 2022, 2 times Pillar 1 plus 2 times Pillar 2A, equivalent to 25.4 per cent of risk-weighted assets

The Bank of England will review the calibration of MREL in 2020 before setting final end-state requirements to be met from 2022. This review will take into consideration any changes to the capital framework, including the finalisation of Basel III.

During 2018, the Group issued £8.8 billion (sterling equivalent) of senior unsecured securities from Lloyds Banking Group plc which, while not included in total capital, are eligible to meet MREL. Combined with previous issuances made over the last two years the Group remains comfortably positioned to meet MREL requirements from 2020 and, as at 31 December 2018, had a transitional MREL ratio of 32.4 per cent of risk-weighted assets.

Analysis of capital position

The Group's CET1 capital ratio increased by 2.10 per cent on an adjusted basis before ordinary dividends and the share buyback, primarily as a result of:

- Strong underlying capital build, net of remediation costs, of 1.95 per cent, largely driven by underlying profits
- Dividends paid by the Insurance business in July 2018 and in February 2019, in relation to 2018 earnings generating an increase of 0.25 per cent
- The completion of the sale of the Irish mortgage portfolio in the second half of the year which resulted in a 0.25 per cent increase
- Other movements, resulting in a net increase of 0.03 per cent, included the impact of structural changes arising from transfer between Insurance and the ring-fenced bank, risk-weighted asset reductions, market movements and additional pension contributions
- Offset by a reduction of 0.38 per cent relating to PPI charges

The implementation of IFRS 9 on 1 January 2018 resulted in an initial reduction in CET1 capital of 0.30 per cent which, following the application of transitional relief, reduced to 0.01 per cent. No additional relief has been recognised at 31 December 2018 as Stage 1 and Stage 2 expected credit losses (ECLs), net of regulatory expected losses, have not increased beyond the position at 1 January 2018.

Overall the Group's CET1 ratio has strengthened to 16.0 per cent on an adjusted basis before ordinary dividends and the share buyback. After ordinary dividends the Group's CET1 ratio reduces to 14.8 per cent on an adjusted basis. In addition the Board intends to implement a share buyback programme of up to £1.75 billion, equivalent to 2.46 pence per share. The buyback will impact the Group's capital position in 2019 and is expected to reduce CET1 capital by c. 0.9 per cent. Allowing for this at 31 December 2018 the adjusted CET1 ratio would be 13.9 per cent after ordinary dividends (31 December 2017: 13.9 per cent adjusted, after ordinary dividends and the share buyback).

Excluding the Insurance dividend paid in February 2019 the Group's CET1 ratio has strengthened to 15.8 per cent before ordinary dividends and the share buyback and 14.6 per cent after ordinary dividends (31 December 2017: 14.1 per cent).

The accrual for foreseeable dividends reflects the recommended final ordinary dividend of 2.14 pence per share.

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The transitional total capital ratio, after ordinary dividends, increased by 1.7 per cent to 22.9 per cent, largely reflecting the issuance of new AT1 and dated subordinated debt instruments, foreign exchange movements on subordinated debt instruments, the reduction in the significant investments deduction from tier 2 capital, the increase in CET1 capital and the reduction in risk-weighted assets, partially offset by the amortisation of dated tier 2 instruments and the annual reduction in the transitional limit applied to grandfathered AT1 capital instruments.

Total capital requirement

The Group's total capital requirement (TCR) as at 31 December 2018, being the aggregate of the Group's Pillar 1 and current Pillar 2A capital requirements, was £26,124 million (31 December 2017: £28,180 million).

Capital resources

An analysis of the Group's capital position as at 31 December 2018 is presented in the following section on both a CRD IV transitional arrangements basis and a CRD IV fully loaded basis. In addition the Group's capital position reflects the application of the transitional arrangements for IFRS 9.

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Table 1.27: **Capital resources (audited)**

The table below summarises the consolidated capital position of the Group. The Group's Pillar 3 Report will provide a comprehensive analysis of the own funds of the Group.

	Transitional		**Fully loaded**	
	At 31 Dec 2018 £m	At 31 Dec 2017 £m	**At 31 Dec 2018 £m**	At 31 Dec 2017 £m
Common equity tier 1				
Shareholders' equity per balance sheet	**43,434**	43,551	**43,434**	43,551
Adjustment to retained earnings for foreseeable dividends	**(1,523)**	(1,475)	**(1,523)**	(1,475)
Deconsolidation adjustments[1]	**2,273**	1,301	**2,273**	1,301
Adjustment for own credit	**(280)**	109	**(280)**	109
Cash flow hedging reserve	**(1,051)**	(1,405)	**(1,051)**	(1,405)
Other adjustments	**(19)**	(177)	**(19)**	(177)
	42,834	41,904	**42,834**	41,904
less: deductions from common equity tier 1				
Goodwill and other intangible assets	**(3,667)**	(2,966)	**(3,667)**	(2,966)
Prudent valuation adjustment	**(529)**	(556)	**(529)**	(556)
Excess of expected losses over impairment provisions and value adjustments	**(27)**	(498)	**(27)**	(498)
Removal of defined benefit pension surplus	**(994)**	(541)	**(994)**	(541)
Securitisation deductions	**(191)**	(191)	**(191)**	(191)
Significant investments[1]	**(4,222)**	(4,250)	**(4,222)**	(4,250)
Deferred tax assets	**(3,037)**	(3,255)	**(3,037)**	(3,255)
Common equity tier 1 capital	**30,167**	29,647	**30,167**	29,647
Additional tier 1				
Other equity instruments	**6,466**	5,330	**6,466**	5,330
Preference shares and preferred securities[2]	**4,008**	4,503	**–**	–
Transitional limit and other adjustments	**(1,804)**	(1,748)	**–**	–
	8,670	8,085	**6,466**	5,330
less: deductions from tier 1				