Summary of Group results

Our strategy

Our strategy remains to grow the business through developing long term customer relationships and building our customer franchise. All our businesses are focused on extending the reach and depth of our customer relationships, enhancing product capabilities to build competitive advantage, and improving processing efficiency whilst working capital harder. This will enable us to achieve our vision of being the best financial services organisation in the United Kingdom.

The focus on developing our relationships with personal, commercial and corporate customers, whilst developing innovative products that meet the needs of existing customers and attract new customers, is a key driver for income and business growth. Ensuring we become more efficient in everything we do will help ensure our costs are managed effectively whilst also enabling us to invest in the business to drive further growth. Resource allocation is also increasingly important and significant focus is given to allocating capital to where it will have the most positive impact on our businesses.

Our focus remains on the core business within the UK and in 2007 we continued to move out of non-core markets with the sale of Lloyds TSB Registrars and Abbey Life.

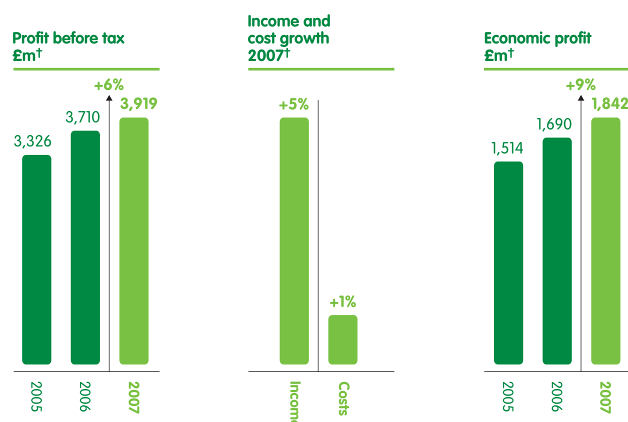
We are already making excellent progress in building the customer franchise and Lloyds TSB is the leading recruiter of new personal current accounts in the UK and has the leading share of new business start-ups. The 2007 results highlight we are on the right track, both in terms of our financial performance and in making further progress in the development of our organic growth strategy.

We believe there remains significant opportunity for organic growth and as we successfully grow the business and develop our skills and capabilities, we will look to expand from a solid foundation of strength. This is likely to be through leveraging our financial strength and enhanced capabilities in new product, customer and geographic markets.

Group results

	2007 £m	2006 £m
Net interest income	6,092	5,360
Other income	12,636	13,903
Total income	18,728	19,263
Insurance claims	(7,522)	(8,569)
Total income, net of insurance claims	11,206	10,694
Operating expenses	(5,491)	(5,429)
Trading surplus	5,715	5,265
Impairment	(1,796)	(1,555)
Profit before tax*	3,919	3,710
Volatility		
– Insurance	(267)	84
– Policyholder interests	(233)	326
Profit on sale of businesses	657	–
Settlement of overdraft claims	(76)	–
Pension schemes related credit	–	128
Profit before tax	4,000	4,248

* Excluding volatility, profit on sale of businesses, the settlement of overdraft claims in 2007 and the pension schemes related credit in 2006.



† Excluding volatility, profit on sale of businesses, the settlement of overdraft claims in 2007, the pension schemes related credit in 2006, and customer redress provisions and the strengthening of reserves for mortality in 2005.

Summary of Group results

In 2007 the Group delivered a strong performance against the backdrop of significant turbulence in global financial markets. Statutory profit attributable to equity shareholders increased by £486 million, or 17 per cent, to £3,289 million and earnings per share increased by 17 per cent to 58.3p. Economic profit increased by 21 per cent to £2,238 million, and the post-tax return on equity improved from 26.6 per cent to 28.2 per cent. Profit before tax fell by 6 per cent to £4,000 million, largely as a result of significant adverse policyholder interests volatility.

To enable meaningful comparisons to be made with 2006, the income statement commentaries below exclude insurance related volatility, the profit on sale of businesses, settlement of overdraft claims in 2007 and the pension schemes related credit in 2006.

Building strong customer relationships

Lloyds TSB's strategy to build strong customer franchises and grow our business by realising the considerable potential within those franchises continues to deliver strong results. We have continued to extend the reach and depth of our customer relationships, achieving good sales growth, whilst also improving productivity and efficiency. The underlying performance of the business remains strong with revenue growth remaining well ahead of cost growth.

Like many other financial institutions, the Group has been affected by the recent market dislocation; however, the relationship focus of our strategy has meant that the impact on the Group's profit before tax was limited to £280 million in 2007 (£188 million reduction in income; £92 million increase in impairment).

Continued momentum throughout the business

Profit before tax increased by £209 million, or 6 per cent, to £3,919 million, underpinned by good relationship banking momentum, notwithstanding the impact of the £280 million market dislocation in Corporate Markets. Revenue growth of 5 per cent exceeded cost growth of 1 per cent, with each division delivering stronger revenue growth than cost growth. Earnings per share increased by 8 per cent to 50.8p and economic profit increased by 9 per cent to £1,842 million. Excluding the impact of market dislocation, Group profit before tax increased by 13 per cent to £4,199 million.

> **"Lloyds TSB's strategy to build strong customer franchises and grow our business by realising the considerable potential within those franchises continues to deliver strong results."**

Good income growth

Overall, income growth of 5 per cent reflects good progress in delivering our divisional strategies. We have increased income from both new and existing customers, with strong growth in both assets and liabilities, as well as a significant increase in fee-related income. Excluding the impact of market dislocation and insurance grossing, income increased by 6 per cent.

Group net interest income, excluding insurance grossing, increased by £349 million, or 7 per cent, to £5,631 million. Customer deposits increased by 12 per cent to £157 billion, supported by strong growth in savings balances in the retail bank, where bank savings increased by 15 per cent and wealth management balances by 12 per cent. Customer deposits in our Corporate Markets, Commercial and International businesses increased by 18 per cent.

Strong levels of customer lending growth in Commercial Banking and Corporate Markets, and good growth in mortgages and retail deposits, more than offset the marketwide experience of lower unsecured personal lending balances. Total assets increased by 3 per cent to £353 billion, with an 11 per cent increase in loans and advances to customers.

The net interest margin from our banking businesses decreased by 9 basis points, to 2.79 per cent, with broadly stable product margins but an adverse mix effect. Stronger growth in finer margin mortgages and flat wider margin unsecured consumer lending contributed to the negative mix effect which accounted for 9 basis points of margin decline. Overall product margins were 2 basis points lower, reflecting competitive pressures in the mortgage and asset finance businesses and a move to finer margin secured lending in Commercial Banking. Funding costs improved the margin by 2 basis points. During the second half of 2007, product margins have started to show signs of improving, with increased new business margins becoming evident in mortgages and corporate lending reflecting a marketwide trend towards more appropriate pricing for risk.

Other income, net of insurance claims and excluding insurance grossing, increased by £133 million, or 2 per cent, to £5,530 million. This reflected higher fees and commissions receivable as a result of strong growth in added value current accounts and higher insurance commissions in the retail bank. In addition, good levels of growth were achieved in fee based product sales to corporate and commercial banking customers.

> **"Overall income growth of 5 per cent reflects good progress in delivering our divisional strategies."**

Excellent cost management

The Group continues to invest in improving processing efficiency, resulting in continued tight control over costs. During 2007, operating expenses increased by only 1 per cent to £5,491 million. Over the last 12 months, staff numbers have fallen by 4,552 (7 per cent) to 58,078, largely as a result of the disposal of Lloyds TSB Registrars and Dutton-Forshaw and further efficiency improvements in back-office processing centres. These improvements in operational effectiveness have resulted in a further reduction in the Group cost:income ratio from 50.8 per cent to 49.0 per cent.

The Group's programme of productivity initiatives has continued to deliver significant benefits, improving underlying cost efficiency and creating greater headroom for further investment in the business. During 2007 the programme delivered net cost reductions of £145 million, exceeding the previously indicated net benefits of approximately £125 million, with gross benefits of £248 million and reinvestment in further programme initiatives of £103 million. The Group remains on track to deliver net benefits of approximately £250 million in 2008.

Along with a number of other UK banks, during the year the Group has received a number of customer claims for the repayment of overdraft fees. On 27 July 2007, several banks, together with the Office of Fair Trading, asked the High Court of England and Wales to clarify the legal position regarding personal current account fees. The 2007 results include a charge of £76 million relating to the settlement of claims during the year, together with related costs.

Overall credit quality remains satisfactory

Impairment losses increased by 15 per cent to £1,796 million. Our impairment charge on loans and advances expressed as a percentage of average lending was 0.82 per cent, excluding the impact of market dislocation and the 2007 Finance Act, compared to 0.83 per cent in 2006. Impaired assets increased by 8 per cent to £5,311 million, less than the rate of lending growth, and now represent 2.5 per cent of total lending, down from 2.6 per cent at 31 December 2006.

In UK Retail Banking, impairment losses decreased by £14 million, or 1 per cent, to £1,224 million. During 2007, we have seen a reduction in the level of customer insolvencies, improvements in the Group's collections procedures and better than assumed recoveries. The quality of new unsecured lending has continued to be strong and our arrears and delinquency trends have improved during the year. In addition, the asset quality of our mortgage portfolio has remained excellent. Whilst the uncertain UK macroeconomic environment and customer insolvency trends remain key factors in the outlook for retail impairment, our current lead indicators are good, we are continuing to enhance our underwriting and collections procedures and the quality of new business remains strong. As a result, based on current trends, we do not expect a significant change in the retail impairment charge in the first half of 2008, compared to the first half of 2007.

The Wholesale and International Banking charge for impairment losses increased by £264 million to £572 million, including a £92 million impairment charge relating to the impact of market dislocation in the second half of 2007, and a one-off charge of £28 million relating to the impact of the 2007 Finance Act on the Group's leasing business. The increase in the impairment charge also reflects a lower level of releases and recoveries in Corporate Markets and the impact of recent double-digit growth rates in Corporate lending.

"We do not expect a significant change in the retail impairment charge in the first half of 2008, compared to the first half of 2007."

Limited exposure to assets affected by current capital markets uncertainties

Whilst no bank has been immune to the impact of the turbulence in global financial markets in the second half of 2007, Lloyds TSB's high quality business model means that the Group has relatively limited exposure to assets affected by current capital markets uncertainties.

US sub-prime Asset Backed Securities (ABS) and ABS Collateralised Debt Obligations (CDOs)

Lloyds TSB has no direct exposure to US sub-prime ABS and limited indirect exposure through ABS CDOs. During the second half of 2007, the market value of our holdings in ABS CDOs reduced and, as a result, the Group has taken an income statement charge of £114 million, leaving a residual investment of £130 million, net of hedges. The write-down largely reflects junior tranches of CDOs which have been written down to the expected interest payments to be received within the next 12 months. The Group has no exposure to mezzanine ABS CDOs. The Group's residual investment of £130 million is stated net of credit default swap (CDS) protection totalling £470 million purchased from a 'triple A' rated monoline Financial Guarantor. At 31 December 2007, the underlying assets supported by this protection had fallen in value, leaving a reliance on the CDS protection totalling £155 million. In addition, we have £1,861 million of ABS CDOs which are fully cash collateralised by major global financial institutions.

Structured Investment Vehicle (SIV) Capital Notes

At 30 June 2007 the Group's exposure to SIV Capital Notes totalled £100 million. During the second half of 2007 the Group wrote down the value of these assets by £22 million, leaving a residual exposure at 31 December 2007 of £78 million. Additionally, at 31 December 2007 the Group had commercial paper back up liquidity facilities totalling £370 million, of which £98 million had been drawn. All of these liquidity lines are senior facilities. Since the year end, these facilities have been reduced to £208 million, of which £115 million has been drawn. The Group has no SIV-Lite exposure.

Trading portfolio

In the second half of 2007, Corporate Markets also saw a reduction in profit before tax of approximately £144 million as a result of the impact of mark-to-market adjustments in the Group's trading portfolio, to reflect the marketwide repricing of liquidity and credit. At 31 December 2007 the trading portfolio contained £181 million of indirect exposure to US sub-prime mortgages and ABS CDOs. This super senior exposure is protected by note subordination.

Available-for-sale assets

At 31 December 2007, the Group's portfolio of available-for-sale assets totalled £20,196 million (31 December 2006: £19,178 million). A significant proportion of these assets (£8.3 billion) related to the ABS in Cancara. The residual assets included £3.2 billion Student Loan ABS, predominantly guaranteed by the US Government, £4.6 billion Government bond and short-dated bank commercial paper and certificates of deposit and £4.1 billion major bank senior paper and high quality ABS. These available-for-sale assets are intended to be held to maturity however, under IFRS, they are marked-to-market through reserves. During 2007, a net £413 million reserves adjustment, which has no impact on the Group's capital ratios, has been made to reflect a reduction in the value of these assets. These assets are not impaired and we expect to obtain full value for them upon maturity.

The Group's investment in Cancara, our hybrid Asset Backed Commercial Paper conduit, was £12.0 billion at 31 December 2007, comprising £8.3 billion ABS and £3.7 billion client receivables transactions. Cancara, which is fully consolidated in the Group's accounts, is managed in a very conservative manner, which is demonstrated by the quality and ratings stability of its underlying asset portfolio. At 31 December 2007, the ABS bonds in Cancara were 100 per cent Aaa/AAA rated by Moody's and Standard & Poor's respectively, and there was no exposure either directly or indirectly to sub-prime US mortgages within the ABS portfolio. Since the year end, ABS totalling £67 million have been downgraded. At 31 December 2007 the client receivables portfolio included £115 million of US sub-prime mortgage exposure.

Scottish Widows has no exposure to US sub-prime ABS either directly or indirectly through CDOs. The Group holds £25 million of short-dated SIV commercial paper through Scottish Widows.

Strong capital management disciplines

Capital efficiency continued to improve throughout the Group, resulting in an increase in post-tax return on average shareholders' equity to 25.2 per cent, and in the post-tax return on average risk-weighted assets to 1.76 per cent, from 1.72 per cent. In our life assurance and investment businesses, the post-tax return on embedded value, on a European Embedded Value (EEV) basis, increased to 9.9 per cent, from 9.3 per cent.

At the end of December 2007, the total capital ratio on a Basel I basis was 11.0 per cent and the tier 1 ratio was 8.1 per cent. During the year, risk-weighted assets increased by 10 per cent to £172.0 billion, reflecting growth in our mortgage and Corporate Markets businesses. Going forward, we expect high single-digit or low double-digit annual growth in risk-weighted assets, reflecting increased opportunities to continue to grow our customer lending. The Group has successfully managed the transition to Basel II and the Group's opening capital ratios on a Basel II basis were 11.0 per cent for total capital and 9.5 per cent for tier 1 capital (page 51).

Scottish Widows remains strongly capitalised and, at the end of December 2007, the working capital ratio of the Scottish Widows Long Term Fund was an estimated 19.2 per cent (page 54). During 2007, further capital repatriation totalling £1.9 billion was made to the Group, bringing the total capital repatriation since the beginning of 2005 to over £3.6 billion. On 5 December 2007 Standard & Poor's announced that it had re-affirmed its Scottish Widows 'AA-' debt rating and placed it on positive outlook.

Maintaining a strong liquidity and funding position

Throughout the recent marketwide liquidity turbulence, Lloyds TSB has maintained a strong liquidity position for both the Group's funding requirements, which are supported by our strong and stable retail and corporate deposit base, and those of its sponsored conduit, Cancara. Retail and corporate deposit inflows have been strong and the Group continues to benefit from its strong credit ratings and diversity of funding sources. This has resulted in the Group continuing to fund well over the last few months. In January 2008, Moody's announced that it had re-affirmed its 'Aaa' long-term debt rating for Lloyds TSB Bank plc.

"Throughout the recent market-wide liquidity turmoil, Lloyds TSB has maintained a strong liquidity position."

Significant reduction in the Group pension schemes' deficit

The Group's defined benefit pension schemes' gross deficit at 31 December 2007 improved by £1,416 million to £683 million, comprising net recognised liabilities of £2,033 million partly offset by unrecognised actuarial gains of £1,350 million. This improvement reflects an increase in the real discount rate used to value the schemes' liabilities and Group contributions to the schemes, which exceeded the cost of accruing benefits.

Substantial profit on sale of non-core businesses

During 2007 the Group sold a number of non-core businesses realising profits on the disposal totalling £657 million. This has further strengthened the Group's capital ratios and improved capital flexibility.

In May 2007, Lloyds TSB Group agreed the sale of the business and assets of Lloyds TSB Registrars to Advent International, subject to completion and other adjustments. The transaction was completed on 30 September 2007, following regulatory approval, and the Group has reported a profit before tax on the sale of this business of £407 million (tax: £nil).

In July 2007, the Group announced an agreement to sell Abbey Life Assurance Company Limited (Abbey Life) to Deutsche Bank AG. This transaction was also completed at the end of September 2007 and the Group has reported a profit before tax on the sale of this business of £272 million (tax: £nil). In addition, a pre-sale dividend of £175 million was paid to Group in June 2007.

Taxation charge

The Group's tax charge for 2007 was £679 million, which was an effective rate of 17.0 per cent (2006: 31.6 per cent). The effective tax rate is below the standard UK corporation tax rate as a result of the gains on disposals being either exempt from tax or covered by capital losses arising in earlier years, a deferred income tax credit following the reduction in the corporation tax rate announced in the 2007 Finance Act, and credits arising on policyholder interests. Under IFRS, the income statement includes a corresponding charge for policyholder interests within the Group's profit before tax. Excluding these items the Group's effective rate of tax was 28.3 per cent.

The 2007 Finance Act reduction in corporation tax rate from 30 per cent to 28 per cent resulted in a one-off impairment charge of £28 million before tax (£20 million after tax), relating to a reduction in future rental income within the Group's leasing business. In addition, the Group's deferred tax liabilities at 31 December 2007 were reduced, resulting in a credit to the Group's tax charge of £110 million. The net impact of these items has been to increase earnings attributable to shareholders by £90 million during the year.

Delivering accelerated earnings momentum, whilst improving profitability and returns

2007 has been a challenging year for all banks, however Lloyds TSB's high quality, more conservative business model has withstood the difficulties of global financial markets turbulence. Strong earnings momentum has continued in the UK retail banking and insurance businesses, and our relationship focused Corporate and Commercial businesses have also continued to perform well. These strong performances have resulted in a good level of income growth which, combined with excellent cost control, has resulted in strong underlying profit momentum. The Group has also continued to maintain satisfactory asset quality. Encouragingly, this performance has not come at the expense of returns, as the Group has continued to improve both its return on equity and return on risk-weighted assets. As a result, the Group is well placed to maintain the recent momentum established throughout the business, and we expect to continue to perform well in 2008.

"The Group is well placed to maintain the recent momentum established throughout the business, and we expect to continue to perform well in 2008."

Summarised segmental analysis

2007	UK Retail Banking £m	Insurance and Investments** £m	Wholesale and International Banking £m	Central group items £m	Group excluding insurance gross up £m	Insurance gross up** £m	Group £m
Net interest income	3,783	68	2,518	(738)	5,631	461	6,092
Other income	1,797	1,900	1,773	362	5,832	6,804	12,636
Total income	5,580	1,968	4,291	(376)	11,463	7,265	18,728
Insurance claims	–	(302)	–	–	(302)	(7,220)	(7,522)
Total income, net of insurance claims	5,580	1,666	4,291	(376)	11,161	45	11,206
Operating expenses	(2,548)	(636)	(2,282)	(6)	(5,472)	(19)	(5,491)
Trading surplus (deficit)	3,032	1,030	2,009	(382)	5,689	26	5,715
Impairment	(1,224)	–	(572)	–	(1,796)	–	(1,796)
Profit (loss) before tax*	1,808	1,030	1,437	(382)	3,893	26	3,919
Volatility							
– Insurance	–	(267)	–	–	(267)	–	(267)
– Policyholder interests	–	–	–	–	–	(233)	(233)
Profit on sale of businesses	–	272	385	–	657	–	657
Settlement of overdraft claims	(76)	–	–	–	(76)	–	(76)
Profit (loss) before tax	1,732	1,035	1,822	(382)	4,207	(207)	4,000

2006	UK Retail Banking £m	Insurance and Investments** £m	Wholesale and International Banking £m	Central group items £m	Group excluding insurance gross up £m	Insurance gross up** £m	Group £m
Net interest income	3,642	56	2,177	(593)	5,282	78	5,360
Other income	1,621	1,740	2,035	201	5,597	8,306	13,903
Total income	5,263	1,796	4,212	(392)	10,879	8,384	19,263
Insurance claims	–	(200)	–	–	(200)	(8,369)	(8,569)
Total income, net of insurance claims	5,263	1,596	4,212	(392)	10,679	15	10,694
Operating expenses	(2,476)	(646)	(2,264)	(51)	(5,437)	8	(5,429)
Trading surplus (deficit)	2,787	950	1,948	(443)	5,242	23	5,265
Impairment	(1,238)	–	(308)	(9)	(1,555)	–	(1,555)
Profit (loss) before tax*	1,549	950	1,640	(452)	3,687	23	3,710
Volatility							
– Insurance	–	84	–	–	84	–	84
– Policyholder interests	–	–	–	–	–	326	326
Pension schemes related credit	–	–	–	128	128	–	128
Profit (loss) before tax	1,549	1,034	1,640	(324)	3,899	349	4,248

* Excluding volatility, profit on sale of businesses, the settlement of overdraft claims in 2007 and the pension schemes related credit in 2006.

** The Group's income statement includes income and expenditure which are attributable to the policyholders of the Group's long-term assurance funds. These items have no impact upon the profit attributable to equity shareholders. In order to provide a clearer representation of the underlying trends within the Insurance and Investments segment, these items are shown within a separate column in the segmental analysis above.

Divisional results

UK Retail Banking

Our business

UK Retail Banking provides a wide range of banking and financial services through our diversified, proprietary distribution network and highly recognised and well-regarded brands (Lloyds TSB, Cheltenham & Gloucester and Scottish Widows) to some 16 million personal customers through over 2,000 branches across the UK. We are the UK's largest personal current account bank with over 12 million current account customers, have the largest number of internet banking customers in the UK and operate 11 call centres, all in the UK, taking 70 million calls per year. Lloyds TSB has been voted the most trusted bank in Britain for seven years running.

Our strategy

UK Retail Banking's strategic priorities are to grow revenue from its existing customer base; expand its customer franchise; and continuously improve productivity and efficiency.

We believe Lloyds TSB can excel through focusing on the needs of our customers. UK Retail Banking's strategy is customer centric with our vision being to help our customers succeed financially so that they reward us with more of their business, stay with us longer and recommend us to others. To deliver this we aim to maximise our advantaged distribution position, our superior risk management skills and our customer understanding and analytical capability whilst developing superior customer focused products, creating a culture of needs based sales and building life long relationships with our customers. Our people remain a competitive advantage.

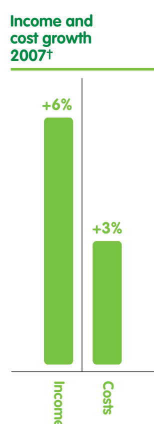
UK Retail Banking results

	2007 £m	2006 £m
Net interest income	3,783	3,642
Other income	1,797	1,621
Total income	5,580	5,263
Operating expenses*	(2,548)	(2,476)
Trading surplus	3,032	2,787
Impairment	(1,224)	(1,238)
Profit before tax*	1,808	1,549
Cost:income ratio*	45.7%	47.0%
Post-tax return on average risk-weighted assets*	2.13%	1.76%

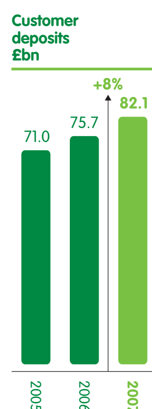
* Excluding the settlement of overdraft claims.

	31 December 2007 £bn	31 December 2006 £bn
Total assets	115.0	108.4
Risk-weighted assets	61.7	59.1
Customer deposits	82.1	75.7

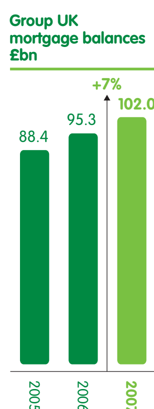
Income and cost growth 2007†



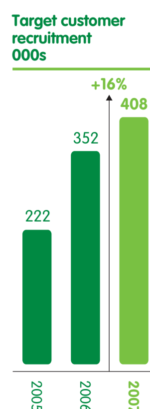
Customer deposits £bn



Group UK mortgage balances £bn



Target customer recruitment 000s



† Excluding the settlement of overdraft claims.

Key highlights

- **Excellent profit performance.** Profit before tax increased by 17 per cent to £1,808 million, excluding the settlement of overdraft claims.
- **Strong income momentum**, up 6 per cent, supported by overall sales growth of 17 per cent.
- **Excellent progress in growing the current account customer franchise**, with over 1 million new current accounts opened, an increase of 17 per cent. New Added Value Accounts increased by 79 per cent. Lloyds TSB is now the UK market leader in new current account customer recruitment.
- **Strong growth in savings deposits** resulted in an 11 per cent increase in savings balances, with 15 per cent growth in bank savings.
- **Stabilisation in net interest margin**, with net interest margin in the second half of 2007 1 basis point higher than in the first half of 2007.
- **Continued good cost management**, with a clear focus on investing to improve service quality and processing efficiency. Excluding the impact of the settlement of overdraft claims, operating expenses increased by 3 per cent and there was a substantial improvement in the cost:income ratio to 45.7 per cent.
- **The quality of new lending continues to be strong.** Arrears levels have continued to improve and the impairment charge in 2007 was lower than in 2006. Whilst the economic outlook for 2008 is uncertain, we do not expect to experience a significant change in the retail impairment charge in the first half of 2008, compared to the first half of 2007.
- **Improved return on risk-weighted assets**, reflecting the impact of double-digit profit growth exceeding the increase in risk-weighted assets.

During 2007, UK Retail Banking continued to make substantial progress in each of its key strategic priorities: growing income from its existing customer base; expanding its customer franchise; and improving productivity and efficiency. In each of these areas, a key focus has been on improving sales of recurring income products, such as current accounts and savings products which, combined with higher lending related income, has supported the accelerating rate of revenue growth.

Profit before tax from UK Retail Banking increased by £183 million, or 12 per cent, to £1,732 million, reflecting strong levels of franchise growth, excellent cost management and a slightly reduced impairment charge. Excluding the settlement of overdraft claims, profit before tax increased by 17 per cent to £1,808 million. Total income increased by £317 million, or 6 per cent, supported by higher income from current accounts, savings and personal lending.

The adverse mix effect of strong growth in finer margin mortgages and flat wider margin unsecured personal lending led to an overall reduction in the division's net interest margin. Product margins on a year-on-year basis fell slightly reflecting competitive pressures in the mortgage business in the first half of 2007 which more than offset an increase in retail savings margins. Towards the end of the year, new business margins in the mortgage business started to improve and this supported a stabilisation in the UK Retail Banking net interest margin in the second half of the year, compared to the first half.

Operating expenses remained well controlled, increasing by 3 per cent, excluding the settlement of overdraft claims. Significant improvements have been made in the rationalisation of back office operations to improve efficiency and we continue to increase the proportion of front office to back office staff in the branch network.

Growing income from the customer base

The Retail Bank has continued to make excellent progress, with further strong growth in product sales and continued good revenue growth. We continue to deliver a very strong performance in the growing savings and investment market, especially in bank savings where we have recently benefited from a significantly improved rate of deposit growth.

"Overall sales increased by 17 per cent, with improvements over a broad range of products, especially current accounts, credit cards and bank savings products."

Overall sales increased by 17 per cent, with improvements over a broad range of products, especially current accounts, credit cards and bank savings products. Sales volumes were particularly strong in the branch network with an increase of 24 per cent. This continued strong sales growth has been driven from high levels of product innovation over the last twelve months with the successful launch of a number of enhanced savings products, an improved range of added value current accounts and the introduction of the innovative Lloyds TSB Duo Airmiles credit card offer. Customer deposits have increased strongly, by 8 per cent over the last twelve months, with particularly strong progress in growing our bank savings and wealth management deposit balances, with increases of 15 per cent and 12 per cent respectively.

Current account and savings balances	31 December 2007 £m	31 December 2006 £m
Bank savings	41,976	36,417
C&G deposits	14,861	14,621
Wealth management	4,939	4,402
UK Retail Banking savings	61,776	55,440
Current accounts	20,305	20,221
Total customer deposits	82,081	75,661

The Group has delivered good levels of mortgage growth, focusing on prime mortgage business and seeking to maintain economic returns. However, as we have previously indicated, our market share of net new mortgage lending in the second half of the year was below our outstanding stock position, reflecting our continued focus on writing value-creating business. The Group continues to focus on those segments of the mortgage market where value can be created while adopting a conservative approach to credit risk. As a result of our focus on managing for value and the recent marketwide increase in interest spreads, new business net interest margins have strengthened. Recent levels of mortgage allocations have been stronger and we expect this to translate into robust balance growth as we move into 2008.

Gross new mortgage lending for the Group totalled £29.4 billion (2006: £27.6 billion). Mortgage balances outstanding increased by 7 per cent to £102.7 billion and net new lending totalled £6.7 billion, resulting in a market share of net new lending of approximately 6.2 per cent.

We have maintained our market leadership position in personal loans, despite tightened credit criteria and a slowdown in consumer demand. Unsecured consumer credit balances were broadly flat with personal loan balances outstanding at 31 December 2007 marginally higher at £11.2 billion, and credit card balances slightly lower at £6.6 billion.

Expanding the customer franchise

In addition to the strong growth in product sales from existing customers, the Group has continued to make progress in expanding its customer franchise. Current account recruitment increased by 17 per cent, compared with last year, supported by the range of added value current accounts, in particular the Silver Account focusing on foreign nationals. During 2007, the Group opened more than 1 million new current accounts.

> **"During 2007, the Group opened more than 1 million new current accounts."**

Wealth Management continues to make good progress with its expansion plans, and over 260 advisers have now been trained on an enhanced wealth management offer comprising private banking, open architecture portfolio management, retirement planning, insurance and estate planning services. As a result, new Investment Portfolio cases increased by 42 per cent and overall wealth management clients increased by 11 per cent. Total new assets under management increased by 42 per cent and wealth management banking deposits grew by 12 per cent.

In June 2007, the Group launched the Lloyds TSB Airmiles Duo account, a new, innovative and exclusive credit card that offers a 'two in one' easy to manage account, with one PIN, one statement and two cards, an American Express and a MasterCard on which customers can earn Airmiles. The demand for this new product has been extremely strong, and over 700,000 cards have been issued to a generally more transactional, high quality, customer segment. As a result, Lloyds TSB was the UK market leader in new credit card issuance during 2007, and now has the largest and fastest growing loyalty credit card programme in the UK.

Improving productivity and efficiency

We have continued to make significant progress in reducing levels of administration and processing work carried out in branches and, as a result, we have increased the number of dedicated customer facing branch network staff by some 4,000 over the last 2 years. Over the same period, branch network staff time spent on back office administration work has reduced from approximately 35 per cent to around 5 per cent. This has enabled us to increase our focus on meeting our customers' needs and has supported the substantially improved branch network sales productivity and service efforts. These improvements have led to the retail banking cost:income ratio, excluding the impact of the settlement of overdraft claims, improving to 45.7 per cent, from 47.0 per cent last year.

In Telephone Banking we have continued to invest in our market leading speech recognition technology which has supported significant growth in the number of customers using our automated service. This, combined with further improvements in the efficiency of our contact centre operations, has led to all customer service calls now being answered from UK based centres.

Impairment levels slightly decreased

Impairment losses on loans and advances decreased by £14 million, or 1 per cent, to £1,224 million, largely reflecting a reduction in the level of customer insolvencies and the quality of new lending. In addition, collections procedures continue to improve, a particularly important competitive advantage in a slowing consumer environment, and we achieved better than assumed recoveries. The impairment charge as a percentage of average lending improved to 1.10 per cent, compared to 1.18 per cent last year. Over 99 per cent of new personal loans and 89 per cent of new credit cards sold during 2007 were to existing customers, where the Group has a better understanding of an individual customer's total financial position. The level of arrears in the personal loan and credit card portfolios reduced during 2007, whilst overdraft arrears remained stable.

> **"We remain very confident in the quality of our mortgage portfolio."**

Mortgage credit quality remains excellent with the impairment charge remaining at a low level of £18 million, or 2 basis points of average mortgage lending. Arrears in the mortgage business have also fallen. In Cheltenham & Gloucester, the average indexed loan-to-value ratio on the mortgage portfolio was 43 per cent, and the average loan-to-value ratio for new mortgages and further advances written during 2007 was 63 per cent. At 31 December 2007, only 1.7 per cent of balances had an indexed loan-to-value ratio in excess of 95 per cent. We extensively stress-test our lending to changes in macroeconomic conditions and we remain very confident in the quality of our mortgage portfolio.

Insurance and Investments

Our business

Insurance and Investments offers life assurance, pensions and investment products, general insurance and fund management services.

The Scottish Widows brand is the main brand for new sales of Lloyds TSB Group's life, pensions, Open Ended Investment Companies and other long-term savings products.

Lloyds TSB General Insurance is the leading distributor of home insurance in Britain, with products distributed through Lloyds TSB Group channels and strategic corporate partners.

Scottish Widows Investment Partnership (SWIP) manages funds for Lloyds TSB Group's retail life, pensions and investment products. Other key clients cover both the retail and institutional segments, with SWIP occupying a top 3 position in terms of retail funds under management. SWIP has close to £100 billion of funds under management.

Our strategy

Insurance and Investments' strategic priorities are maximising bancassurance success, profitably growing IFA sales, improving service and operational efficiency and optimising capital management.

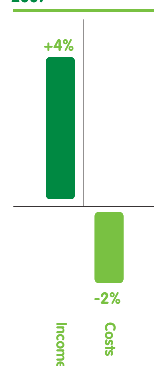
Within Scottish Widows this will be achieved by developing strong and enduring relationships, developing market-led propositions and being easy to do business with. Scottish Widows products are distributed through Lloyds TSB Group channels, independent financial advisers and other intermediaries. Scottish Widows was voted Best Individual Pensions Provider by IFAs and is the most trusted choice for pensions amongst UK consumers.

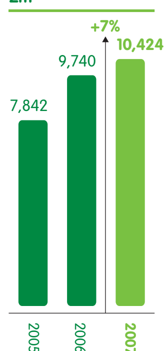
Lloyds TSB General Insurance is targeting growing share in chosen customer segments, developing key insurance partnerships, improving margins by better customer management and improving service and efficiency.

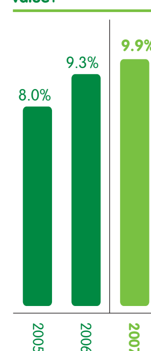
Insurance and Investments results

Excluding volatility and profit on disposal of businesses	2007 £m	2006 £m
Net interest income*	68	56
Other income*	1,900	1,740
Total income	1,968	1,796
Insurance claims*	(302)	(200)
Total income, net of insurance claims	1,666	1,596
Operating expenses*	(636)	(646)
Insurance grossing adjustment (page 14)	26	23
Profit before tax	1,056	973
Profit before tax analysis		
Life, pensions and OEICs	884	701
General insurance	128	243
Scottish Widows Investment Partnership	44	29
Profit before tax	1,056	973
Present value of new business premiums (PVNBP)	10,424	9,740
PVNBP new business margin (EEV basis)	3.1%	3.6%
Post-tax return on embedded value	9.9%	9.3%

* Excluding insurance grossing adjustment.







* Excluding volatility and insurance grossing.
† EEV basis.

Key highlights

- **Strong profit performance.** Profit before tax increased by 9 per cent to £1,056 million. Adjusting for the impact of surplus capital repatriation, profit before tax increased by 13 per cent.
- **Good income growth and excellent cost control.** Income, net of insurance claims and adjusting for the impact of surplus capital repatriation, increased by 7 per cent. Operating expenses decreased by 2 per cent.
- **Good sales performance.** 7 per cent increase in Scottish Widows' present value of new business premiums. Strong progress in increasing bancassurance sales, up 20 per cent. Good performance in the sale of protection products, corporate pensions and retirement income products.
- **Improved returns.** On an EEV basis, the post-tax return on embedded value increased to 9.9 per cent. New business margin was robust at 3.1 per cent.
- **Robust capital position.** Scottish Widows continues to deliver improving capital efficiency and self-financing growth, and a further £1.9 billion of capital was repatriated to the Group during 2007.
- **Increased weather related claims** of £113 million, largely relating to the severe flooding in the UK in June and July, contributed to a 47 per cent reduction in profit before tax in General Insurance.
- **Excellent performance in Scottish Widows Investment Partnership.** Profit before tax increased by 52 per cent reflecting higher margins and improved mix of external business.

Scottish Widows life, pensions and OEICs

Profit before tax increased by £183 million, or 26 per cent, to £884 million. The effect of surplus capital repatriation to the Group has been to reduce investment earnings by a total of £36 million in 2007. Adjusting 2006 for this, profit before tax increased by 33 per cent.

Life and pensions new business profit, on an IFRS basis and excluding volatility, reduced by 5 per cent to £163 million reflecting a change in the mix of investment products sold through the branch network towards non-embedded value accounted products. Total existing business profit grew by 43 per cent to £551 million, partly reflecting increased profits from the growing OEIC portfolio, improved cost management and a reduction in adverse assumption changes compared to 2006. The expected return on shareholders' net assets increased by 43 per cent to £192 million as a result of a higher volume of free assets, driven by strong equity markets and the impact of regulatory changes in 2006, and a higher expected rate of return.

During 2007, Scottish Widows has continued to make strong progress in each of its key business priorities: to maximise bancassurance success; to profitably grow IFA sales; to improve service and operational efficiency; and to optimise capital management.

"During 2007, Scottish Widows has continued to make strong progress in each of its key business priorities."

Maximising bancassurance success

In 2007, the value of Scottish Widows' bancassurance new business premiums increased by 20 per cent, building on the success of the simplified product range for distribution through the Lloyds TSB branch network, Commercial Banking and Wealth Management channels. Sales of protection products were particularly strong. A new branch network creditor insurance and protection product, which replaced an externally provided creditor product, has led to the significant increase in protection sales during 2007. In addition, Scottish Widows launched a new protection product, 'Protection for Life' towards the end of 2006, which has performed very well. We have continued to deliver good sales of OEICs following the more than doubling of sales in 2006.

Profitably growing IFA sales

Sales through the IFA distribution channel increased by 2 per cent, following record A-day related sales levels in 2006. Scottish Widows has continued to focus on the more profitable business areas within the IFA market. Sales of savings and investment products were lower as we chose not to compete in areas which deliver unsatisfactory returns, although this was partly offset by good growth in OEIC sales. Corporate pensions volumes remained strong following excellent growth last year and our managed fund business also showed good improvement.

Improving service and operational efficiency

The business has made continued improvements in service and operational efficiencies, and the benefits can be seen in a reduction of expenses by 2 per cent compared to prior year, notwithstanding the introduction of a number of new products. In addition, customer satisfaction is at its highest ever level. Scottish Widows received a number of awards for service quality and product innovation, including 'Best Individual Pensions Provider' at the Financial Adviser awards whilst maintaining its top quartile position for lowest servicing and acquisition costs per policy.

Optimising capital management

Scottish Widows has maintained its strong focus on improving capital management. During 2007 Scottish Widows continued to deliver a more capital efficient product profile and improved internal rates of return. The post-tax return on embedded value, on an EEV basis, increased to 9.9 per cent, from 9.3 per cent last year. During 2007, £1.9 billion of capital was repatriated to the Group, giving a total capital repatriation of over £3.6 billion since the beginning of 2005.

Present value of new business premiums (PVNBP)	2007 £m	2006 £m
Life and pensions:		
Protection	960	232
Savings and investments	913	1,300
Individual pensions	2,073	2,219
Corporate and other pensions	2,141	1,961
Retirement income	1,044	960
Managed fund business	486	348
Life and pensions	7,617	7,020
OEICs	2,807	2,720
Life, pensions and OEICs	10,424	9,740
Single premium business	8,375	7,321
Regular premium business	2,049	2,419
Life, pensions and OEICs	10,424	9,740
Bancassurance	4,096	3,421
Independent financial advisers	5,817	5,706
Direct	511	613
Life, pensions and OEICs	10,424	9,740

Results on a European Embedded Value (EEV) basis

Lloyds TSB continues to report under IFRS, however, in line with industry best practice, the Group provides supplementary financial reporting for Scottish Widows on an EEV basis. The Group believes that EEV represents the most appropriate measure of long-term value creation in life assurance and investment businesses.

	2007 Life, pensions and OEICs £m	2006 Life, pensions and OEICs £m
New business profit	326	346
Existing business		
– Expected return	337	403
– Experience variances	78	69
– Assumption changes	(45)	(133)
	370	339
Expected return on shareholders' net assets	207	131
Profit before tax, adjusted for capital repatriation*	903	816
Impact of surplus capital repatriation to Group	–	36
Profit before tax*	903	852
New business margin (PVNBP)	3.1%	3.6%
Embedded value (year end)	£5,365m	£6,413m
Post-tax return on embedded value*	9.9%	9.3%

* Excluding volatility and other items.

Adjusting for the impact of capital repatriation, EEV profit before tax from the Group's life, pensions and OEICs business increased by 11 per cent to £903 million.

New business profit fell by £20 million, or 6 per cent, to £326 million, largely reflecting the impact of a higher risk-free discount rate and changes in other economic assumptions applied to new business. This was however offset by a corresponding credit to the expected return on shareholders' net assets.

Existing business profit increased by 9 per cent. Expected return decreased by 16 per cent to £337 million, primarily reflecting a lower shareholder benefit this year from the reduction in the value of realistic balance sheet liabilities and the impact of regulatory changes in 2006. Positive experience variances were driven by higher annuity profits from Abbey Life. Overall lapse experience was broadly in line with the Group's expectations, as higher lapse experience in the life and pensions business was broadly offset by a favourable experience in OEICs. Assumption changes primarily reflect changes to the longer term lapse assumptions for both life and pensions business and OEICs. The expected return on shareholders' net assets increased by £76 million, as a result of a higher volume of free assets, driven by strong equity markets and the impact of regulatory changes in 2006, and a higher expected rate of return.

Overall the post-tax return on embedded value increased to 9.9 per cent from 9.3 per cent. Scottish Widows maintained a strong new business margin of 3.1 per cent. Individual new business product margins remained broadly stable. The overall new business margin fell by 50 basis points however, as a result of an adverse impact from a higher risk-free discount rate and changes in other economic assumptions applied to new business and the shift in product mix resulting from the insourcing of a new branch network creditor insurance and protection product. This product generates a lower new business margin, but delivers good levels of value for the Group.

Scottish Widows Investment Partnership

Pre-tax profit from Scottish Widows Investment Partnership (SWIP) increased by 52 per cent to £44 million, reflecting increased profitability resulting from higher margins and an improved mix of external business, a key strategic priority for SWIP. Over the last 12 months, SWIP's assets under management decreased by £4.1 billion to £97.6 billion, reflecting the decision by the Trustees of the Lloyds TSB pension schemes to move £5.7 billion into external passive management. As a result, institutional funds under management reduced by £5.0 billion. The net movement in retail funds, net of expenses and commissions, was an increase of £2.9 billion.

Movements in funds under management

The following table highlights the movement in retail and institutional funds under management.

	2007 £bn	2006 £bn
Opening funds under management	**105.7**	97.5
Movement in Retail Funds		
Premiums	**11.7**	11.7
Claims	**(4.8)**	(3.6)
Surrenders	**(6.4)**	(5.4)
Net inflow of business	**0.5**	2.7
Investment return, expenses and commission	**2.4**	6.0
Net movement	**2.9**	8.7
Movement in Institutional Funds		
Lloyds TSB pension schemes	**(5.7)**	–
Other institutional funds	**(0.6)**	(1.3)
Investment return, expenses and commission	**1.3**	1.5
Net movement	**(5.0)**	0.2
Proceeds from sale of Abbey Life	**1.0**	–
Dividends and surplus capital repatriation	**(1.9)**	(0.7)
Closing funds under management	**102.7**	105.7
Managed by SWIP	**97.6**	101.7
Managed by third parties	**5.1**	4.0
Closing funds under management	**102.7**	105.7

Including assets under management within our UK Wealth Management and International Private Banking businesses, Groupwide funds under management decreased by 3 per cent to £122.8 billion.

European Embedded Value reporting - results for year ended 31 December 2007

This section provides further details of the Scottish Widows EEV financial information.

Composition of EEV balance sheet

	2007 £m	2006 £m
Value of in-force business (certainty equivalent)	2,779	3,220
Value of financial options and guarantees	(53)	(56)
Cost of capital	(178)	(248)
Non-market risk	(61)	(75)
Total value of in-force business	2,487	2,841
Shareholders' net assets	2,878	3,572
Total EEV of covered business	5,365	6,413

Reconciliation of opening EEV balance sheet to closing EEV balance sheet on covered business

	Shareholders' net assets £m	Value of in-force business £m	Total £m
As at 1 January 2006	3,445	2,941	6,386
Total profit after tax	873	(100)	773
Dividends	(746)	–	(746)
As at 31 December 2006	3,572	2,841	6,413
Total profit after tax	661	107	768
Profit on disposal of Abbey Life (EEV basis)			
– Sale proceeds	985	–	985
– Assets disposed	(474)	(461)	(935)
	511	(461)	50
Dividends	(1,866)	–	(1,866)
As at 31 December 2007	2,878	2,487	5,365

Analysis of shareholders' net assets on an EEV basis on covered business

	Required capital £m	Free surplus £m	Shareholders' net assets £m
As at 1 January 2006	2,393	1,052	3,445
Total profit after tax	(186)	1,059	873
Dividends	–	(746)	(746)
As at 31 December 2006	2,207	1,365	3,572
Total (loss) profit after tax	(238)	899	661
Disposal of Abbey Life (EEV basis)	(232)	743	511
Dividends	–	(1,866)	(1,866)
As at 31 December 2007	1,737	1,141	2,878

Divisional results

Summary income statement on an EEV basis

	2007 £m	2006 £m
New business profit	326	346
Existing business profit		
– Expected return	337	403
– Experience variances	78	69
– Assumption changes	(45)	(133)
	370	339
Expected return on shareholders' net assets	207	167
Profit before tax, excluding volatility and other items*	903	852
Volatility	(271)	176
Other items*	58	76
Total profit before tax	690	1,104
Taxation	(59)	(331)
Impact of Corporation tax rate change	137	–
Total profit after tax, excluding profit on sale of Abbey Life	768	773
Profit on sale of Abbey Life (EEV basis)	50	–
Total profit after tax	818	773

* Other items represent amounts not considered attributable to the underlying performance of the business.

Breakdown of income statement between life and pensions, and OEICs

2007	Life and pensions £m	OEICS £m	Total £m
New business profit	270	56	326
Existing business			
– Expected return	286	51	337
– Experience variances	35	43	78
– Assumption changes	(105)	60	(45)
	216	154	370
Expected return on shareholders' net assets	199	8	207
Profit before tax*	685	218	903
New business margin (PVNBP)	3.5%	2.0%	3.1%
Post-tax return on embedded value*			9.9%

2006	Life and pensions £m	OEICS £m	Total £m
New business profit	287	59	346
Existing business			
– Expected return	361	42	403
– Experience variances	35	34	69
– Assumption changes	(129)	(4)	(133)
	267	72	339
Expected return on shareholders' net assets	160	7	167
Profit before tax*	714	138	852
New business margin (PVNBP)	4.1%	2.2%	3.6%
Post-tax return on embedded value*			9.3%

* Excluding volatility and other items.

Economic assumptions

A bottom up approach is used to determine the economic assumptions for valuing the business in order to determine a market consistent valuation.

The risk-free rate assumed in valuing in-force business is 10 basis points over the 15 year gilt yield. In valuing financial options and guarantees the risk-free rate is derived from gilt yields plus 10 basis points, in line with Scottish Widows' FSA realistic balance sheet assumptions. The table below shows the range of resulting yields and other key assumptions.

	31 December 2007 %	31 December 2006 %
Risk-free rate (value of in-force)	**4.65**	4.72
Risk-free rate (financial options and guarantees)	**4.28 to 4.81**	3.91 to 5.41
Retail price inflation	**3.28**	3.23
Expense inflation	**4.18**	4.13

Non-market risk

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

Non-economic assumptions

Future mortality, morbidity, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management's view of future experience. These assumptions are intended to represent a best estimate of future experience.

For OEIC business, the lapse assumption is based on recent experience which has been collected over a period that has coincided with favourable investment conditions. Management have used a best estimate of the long-term lapse assumption which is higher than indicated by this experience. In management's view, the approach and lapse assumption are both reasonable.

Sensitivity analysis

The table below shows the sensitivity of the EEV and the new business profit before tax to movements in some of the key assumptions. The impact of a change in the assumption has only been shown in one direction other than for risk free rate. Where the impact has been shown only in one direction it can be assumed to be reasonably symmetrical.

	Impact on EEV £m	Impact on new business profit before tax £m
2007 EEV/new business profit before tax	**5,365**	**326**
100 basis points reduction in risk-free rate[1]	161	7
100 basis points increase in risk-free rate[1]	(115)	(7)
10 per cent reduction in market values of equity assets[2]	(178)	n/a
10 per cent reduction in market values of property assets[3]	(32)	n/a
10 per cent reduction in expenses[4]	96	31
10 per cent reduction in lapses[5]	88	19
5 per cent reduction in annuitant mortality[6]	(64)	(5)
5 per cent reduction in mortality and morbidity (excluding annuitants)[7]	22	3
100 basis points increase in equity and property returns[8]	nil	nil
10 basis points increase in credit spreads[9]	(46)	(6)

[1] In this sensitivity the impact takes into account the change in the value of in-force business, financial options and guarantee costs, statutory reserves and asset values.

[2] The reduction in market values is assumed to have no corresponding impact on dividend yields.

[3] The reduction in market values is assumed to have no corresponding impact on rental yields.

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

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

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

[7] This sensitivity shows the impact of reducing mortality rates on non-annuity business to 95 per cent of the expected rate.

[8] Under a market consistent valuation, changes in assumed equity and property returns have no impact on the EEV.

[9] This sensitivity shows the impact of a 10 basis point increase in corporate bond yields and the corresponding reduction in market values. Government bond yields and the risk-free rate are assumed to be unchanged.

In sensitivities 4 to 7 assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and the statutory reserving bases. A change in risk discount rates is not relevant as the risk discount rate is not an input to a market consistent valuation.

General insurance

	2007 £m	2006 £m
Commission receivable	**648**	629
Commission payable	**(692)**	(664)
Underwriting income (net of reinsurance)	**591**	600
Other income	**37**	35
Net operating income	**584**	600
Claims paid on insurance contracts (net of reinsurance)	**(302)**	(200)
Operating income, net of claims	**282**	400
Operating expenses	**(154)**	(157)
Profit before tax	**128**	243
Claims ratio	**49%**	32%
Combined ratio	**93%**	80%

Profit before tax from our general insurance operations decreased by £115 million, to £128 million, largely as a result of a £113 million increase in weather related claims, primarily reflecting severe flooding in the UK in June and July. Net operating income decreased by 3 per cent whilst costs were reduced by 2 per cent.

Net operating income decreased by £16 million, or 3 per cent, as growth in home and loan protection income was more than offset by lower motor insurance income, increased reinsurance costs and the run-off from the legacy health portfolio. Our continued focus on improving operational efficiency and improving the effectiveness of our marketing spend has resulted in a £3 million, or 2 per cent, reduction in operating costs, whilst also continuing to improve processing efficiency.

Overall sales performance has been good with an 8 per cent increase in new business gross written premiums (GWP). Home insurance sales through the branch network continue to perform well with 14 per cent growth in new business GWP. We have, however, scaled back our participation in the distribution of home insurance through direct channels, as a result of the increasingly competitive pricing in that area of the market. During the year we continued to invest in product development, with loan protection and home insurance products both securing industry leading external quality ratings.

Income, net of claims, was £118 million lower, largely as a result of the increased extreme weather related claims, following a benign period in 2006. As a result, overall claims increased by £102 million, and key underwriting ratios were significantly affected with an increase in the claims ratio to 49 per cent, and an increase in the combined ratio to 93 per cent. Adjusting for the extreme weather related claims, the claims ratio improved, reflecting both a favourable claims experience in our home insurance underwriting and the impact of recent investment in improving the efficiency of our claims processing.

The business continues to invest in the development of its Corporate Partnership distribution arrangements and the performance of the Pearl business acquired in 2006 has exceeded our initial expectations.

Wholesale and International Banking

Our business

Our businesses within the Wholesale and International Banking arena cover a broad scope, serving thousands of customers, ranging from start-ups and small enterprises to large organisations and global corporations. Combining the respective strengths of some 3,000 people in Corporate Banking and Products & Markets, Corporate Markets plays an integral role in leveraging and expanding the customer franchise and building deep, long-lasting relationships with around 17,000 corporate customers and was awarded with 'Real Finance/CBI FDs' Excellence Awards – Corporate Bank of the Year' for the third year running. Commercial Banking is a growing business with some 5,500 people serving nearly one million customers across the UK from one-person start-ups to large, established enterprises. Lloyds TSB Group has a leading share of the new business start-up market, with some 120,000 new businesses opening an account in 2007. We also participate in specialist markets with a range of solutions including personal and international expatriate and private banking, motor and leisure finance and auto leasing.

Our strategy

The Wholesale and International Banking strategic vision is to be the best UK mid-market focused wholesale bank and to compete successfully in selected, relevant global markets. Our key strategic priorities are to grow the Corporate Markets business; build on the growth momentum in Commercial Banking; and maintain strong asset quality.

Making Wholesale and International Banking a great place for our customers to bank is our number one priority. As a relationship bank, we place our customers at the forefront of our vision and we strive, with passion, to meet their needs. The way by which we manage our customer relationships is the vital ingredient in what differentiates us from our competition.

We use our strong product capabilities to support our new and existing customer relationships, with primary current focus being placed on the UK corporate segment in which energies and resource are directed to achieve gains in profitable market share thereby creating long term, sustainable relationships with our customers.

Wholesale and International Banking results

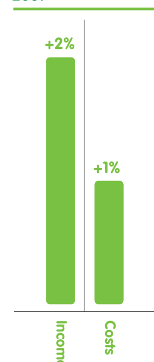
	2007 £m	2006 £m
Net interest income	2,518	2,177
Other income	1,773	2,035
Total income	4,291	4,212
Operating expenses	(2,282)	(2,264)
Trading surplus	2,009	1,948
Impairment	(572)	(308)
Profit before tax*	1,437	1,640
Cost:income ratio	53.2%	53.8%
Post-tax return on average risk-weighted assets*	1.13%	1.38%

	31 December 2007 £bn	31 December 2006 £bn
Total assets	163.3	147.8
Risk-weighted assets	105.1	91.8
Customer deposits	72.3	61.2

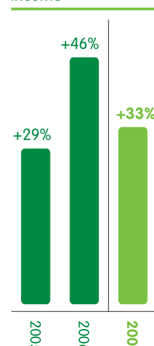
	2007 £m	2006 £m
Profit before tax by business unit*		
Corporate Markets		
– Before impact of market dislocation	1,132	1,030
– Impact of market dislocation	(280)	–
	852	1,030
Commercial Banking	451	398
Asset Finance	60	113
International Banking and other businesses	74	99
	1,437	1,640

* Excluding profit on sale of businesses.

Income and cost growth 2007

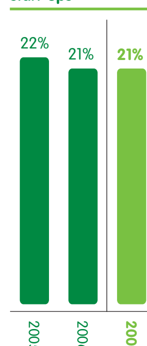


Growth in cross-selling income



Corporate Markets profit before tax £m†

Market share of Commercial Banking start-ups



† Before impact of market dislocation.

Key highlights

- **Overall profits impacted by turbulence in global financial markets.** Whilst the division has limited exposure to assets affected by current capital market uncertainties, the impact of recent market dislocation has been to reduce profit before tax in 2007 by £280 million.
- **Continued relationship banking momentum.** Excluding the impact of market dislocation, profit before tax increased by 5 per cent.
- **Further good progress in expanding our Corporate Markets business**, with an 18 per cent increase in Corporate Markets income supporting a 10 per cent increase in profit before tax, excluding the impact of market dislocation.
- **Continued strong franchise growth in Commercial Banking**, with an 8 per cent growth in income and a 13 per cent growth in profit before tax. Lloyds TSB has retained its leading position as the bank of choice for start-up businesses.
- **Continued tight credit control in Asset Finance**, and a slowdown in demand in the consumer lending portfolio, led to a 47 per cent reduction in profit before tax.
- **Strong risk management and good asset quality**, despite a rise of £264 million in impairment losses, largely as a result of the £92 million impact of market dislocation, a £28 million provision reflecting the impact of the 2007 Finance Act on the division's leasing business, and a lower level of corporate releases and recoveries during the year.

In Wholesale and International Banking, the Group has continued to make significant progress in its strategy to develop the Group's strong corporate and small to medium business customer franchises and, in doing so, become the best UK mid-market focused wholesale bank. The division has continued to make substantial progress in its relationship banking businesses. In Commercial Banking, strong growth in business volumes, further customer franchise improvements and good progress in improving operational efficiency have resulted in continued strong profit growth. In Corporate Markets, further good progress has been made in developing our relationship banking franchise supported by a strong cross-selling performance.

Overall, the division's profit before tax decreased by 12 per cent, to £1,437 million, reflecting the £280 million reduction in profits as a result of market dislocation. Excluding this impact, profit before tax increased by 5 per cent, with a continued strong performance in our relationship banking businesses. This has generated overall income growth of 6 per cent, driven by strong Corporate Markets and Commercial Banking income growth of 18 per cent and 8 per cent respectively. This exceeded cost growth of 1 per cent, leading to a reduction in the cost:income ratio to 50.9 per cent, from 53.8 per cent last year. Trading surplus, excluding the impact of market dislocation, increased by £249 million, or 13 per cent, to £2,197 million.

> **"In Wholesale and International Banking, the Group has continued to make significant progress in its strategy to leverage the Group's strong corporate and small to medium business customer franchises."**

The charge for impairment losses on loans and advances increased by £264 million to £572 million, largely as a result of the £92 million impact of market dislocation, a one-off £28 million impairment charge reflecting a reduction in rental income from operating lease activities following the corporation tax rate change included in the 2007 Finance Act, a lower level of releases and recoveries during the year and the impact of recent strong growth in the corporate lending portfolio. Overall corporate and SME asset quality remains good although we continue to expect some normalisation in the impairment charge over the next few years. We do believe, however, that we remain relatively well positioned as a result of our prudent credit management policy.

Divisional results

Corporate Markets	2007 £m	2006 £m
Net interest income	**1,104**	806
Other income		
– Before market dislocation	**808**	821
– Market dislocation	**(188)**	–
	620	821
Total income	**1,724**	1,627
Operating expenses	**(632)**	(615)
Trading surplus	**1,092**	1,012
Impairment		
– Before market dislocation	**(148)**	18
– Market dislocation	**(92)**	–
	(240)	18
Profit before tax	**852**	1,030

In Corporate Markets, profit before tax fell by 17 per cent, however, excluding the impact of market dislocation and the 2007 Finance Act, profit before tax increased by 13 per cent. On this basis, income increased by 18 per cent, supported by continued high levels of cross-selling income, strong growth in corporate lending and a higher level of income from venture capital investments. The strong growth in lending was supported by an increase of £4.7 billion in Group lending to property companies, to £17.6 billion. Two-thirds of this lending portfolio is commercial property lending supporting our existing customer franchise and reflects a well-spread nationwide portfolio. We adopt conservative credit criteria and the indexed loan-to-value of the portfolio is approximately 62 per cent. One third of the portfolio is residential lending, over half of which is to local authority backed public housing.

"Corporate Markets underlying income increased by 18 per cent, supported by continued high levels of cross-selling income."

Operating expenses increased by 3 per cent to £632 million, reflecting further investment in people to support ongoing business growth. The trading surplus, excluding market dislocation, increased by 26 per cent. The impairment charge of £240 million includes £92 million from the impact of market dislocation and the £28 million one-off charge relating to the impact of the 2007 Finance Act on the division's leasing business. Excluding these items, the underlying increase in the impairment charge reflects lower levels of releases and recoveries, recent strong growth in corporate customer lending and impairments relating to two special situations.

Commercial Banking	2007 £m	2006 £m
Net interest income	**890**	821
Other income	**429**	397
Total income	**1,319**	1,218
Operating expenses	**(769)**	(727)
Trading surplus	**550**	491
Impairment	**(99)**	(93)
Profit before tax	**451**	398

Profit before tax in Commercial Banking grew by £53 million, or 13 per cent, reflecting strong growth in business volumes, further improvements in growing the Commercial Banking customer franchise and progress in improving operational efficiency. Income increased by 8 per cent to £1,319 million, reflecting strong growth in lending and deposit balances, whilst costs were 6 per cent higher, as a result of increased investment to improve the operating platform. Commercial Banking continued to develop and grow its customer franchise strongly, with customer recruitment of 120,000 during 2007, reflecting its market-leading position in the start-up market with a market share of 21 per cent. We also made good progress in continuing to attract customers 'switching' from other financial services providers. Lloyds TSB Commercial Finance has continued to improve its strong market position, with a market share of approximately 20 per cent, measured by client numbers. Asset quality in the Commercial Banking portfolios remains good with impairment charges as a percentage of average lending reducing by 7 basis points to 0.60 per cent, partly reflecting our move to increase levels of secured lending.

"Income increased by 8 per cent to £1,319 million, reflecting strong growth in lending and deposit balances."

Asset Finance	2007 £m	2006 £m
Net interest income	299	331
Other income	472	529
Total income	771	860
Operating expenses	(483)	(508)
Trading surplus	288	352
Impairment	(228)	(239)
Profit before tax	60	113

Profit before tax in Asset Finance decreased by 47 per cent to £60 million, largely reflecting continued tight credit criteria and a slowdown in demand in the consumer lending portfolio which has led to a reduction in the level of new business underwritten. As a result, income decreased by £89 million, or 10 per cent. Costs were 5 per cent lower and the impairment charge decreased by £11 million to £228 million, reflecting the recent tightening of credit criteria, improved collections procedures and lower balances outstanding, which offset an increase in arrears. Conditions in the Motor Finance business remain challenging. New business volumes have reduced, reflecting the marketwide slowdown in consumer demand, and we have sought to avoid the structural contraction in interest margins. In Personal Finance, new business volumes have risen modestly in a fiercely competitive market. Our Contract Hire business, Autolease, has performed well by continuing to leverage its strong market position and efficient operation.

Central group items

	2007 £m	2006 £m
Lloyds TSB Foundations	(37)	(37)
Funding cost of acquisitions less earnings on capital	(378)	(378)
Central costs and other unallocated items	33	(37)
Pension schemes related credit	–	128
Loss before tax	**(382)**	(324)

The four independent Lloyds TSB Foundations support registered charities throughout the UK that enable people, particularly disabled and disadvantaged, to play a fuller role in society. The Foundations receive 1 per cent of the Lloyds TSB Group's pre-tax profit after adjusting for gains and losses on the disposal of businesses and pre-tax minority interests, averaged over three years, instead of a dividend on their shareholdings. In 2007, £37 million was accrued for payment to registered charities.

Following changes in age discrimination legislation in 2006, the Group ceased to augment the pension entitlement of employees taking early retirement; this change reduced the Group's defined benefit pension liability at 31 December 2006 by £129 million (£1 million of which was unrecognised) and resulted in a one-off credit to the 2006 income statement of £128 million.

Volatility

Banking volatility

Since the introduction of IFRS in 2005, in order to provide a clearer view of the underlying performance of the business, the Group has separately disclosed within Central group items the effects of marking-to-market derivatives held for risk management purposes. This amount, net of the effect of the Group's IAS 39 compliant hedge accounting relationships, was previously disclosed as banking volatility.

The use of fair values in financial reporting is now more widespread and there is a better understanding of their effects; consequently, in line with evolving best practice, the Group no longer considers it appropriate to disclose banking volatility separately. Divisions will continue to transfer, through the Group's internal transfer pricing arrangements, to Group Corporate Treasury (included in Central Group Items) the movements in the market value of hedging derivatives where the impact is not locally managed.

Insurance volatility

The Group's insurance businesses have liability products that are supported by substantial holdings of investments, including equities, property and fixed interest investments, all of which have a volatile fair value. The value of the liabilities does not move exactly in line with changes in the fair value of the investments, yet IFRS requires that the changes in both the value of the liabilities and investments be reflected within the income statement. As these investments are substantial and movements in their fair value can have a significant impact on the profitability of the Insurance and Investments division, management believes that it is appropriate to disclose the division's results on the basis of an expected return in addition to the actual return. The difference between the actual return on these investments and the expected return based upon economic assumptions made at the beginning of the year is included within insurance volatility.

Changes in market variables also affect the realistic valuation of the guarantees and options embedded within products written in the Scottish Widows With Profit Fund, the value of the in-force business and the value of shareholders' funds. Fluctuations in these values caused by changes in market variables, including market spreads reflecting credit risk premia, are also included within insurance volatility. These market credit spreads represent the gap between the yield on corporate bonds and the yield on government bonds, and reflect the market's assessment of credit risk. Changes in the credit spreads affect the value of the in-force business asset in respect of the annuity portfolio.

The expected investment returns used to determine the normalised profit of the business, which are based on prevailing market rates and published research into historic investment return differentials, are set out below:

	2008 %	2007 %	2006 %
Gilt yields (gross)	4.55	4.62	4.12
Equity returns (gross)	7.55	7.62	6.72
Dividend yield	3.00	3.00	3.00
Property return (gross)	7.55	7.62	6.72
Corporate bonds (gross)	5.15	5.22	4.72

During 2007, profit before tax included negative insurance volatility of £267 million, being a credit of £7 million to net interest income and a charge of £274 million to other income (2006: positive volatility of £84 million, being a credit of £2 million to net interest income and a credit of £82 million to other income). The effect of widening credit risk spreads and falling gilt values more than offset the favourable impact of a modest increase in equity values and changes in market consistent assumptions. During 2006 increases in equity values were partly offset by lower gilt values.

Policyholder interests volatility

As a result of the requirement under IFRS to consolidate the Group's life and pensions businesses on a line-by-line basis, the Group's income statement includes amounts attributable to policyholders which affect profit before tax; the most significant of these items is policyholder tax.

Under IFRS, tax on policyholder investment returns is required to be included in the Group's tax charge rather than being offset against the related income, as it is in actual distributions made to policyholders. The impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Other items classified within policyholder interests volatility include the effects of investment vehicles which are only majority owned by the long-term assurance funds. In the case of these vehicles, the Group's profit for the year includes the minorities' share of the profits earned. As set out below these amounts do not accrue to the equity holders, accordingly management believes a clearer representation of the underlying performance of the Group's life and pensions businesses is presented by excluding policyholder interests volatility.

	2007 £m	2006 £m
Net interest income	–	(33)
Other income	(233)	359
Profit before tax	(233)	326
Taxation – policyholder	243	(222)
Minority interests	(10)	(104)
Profit attributable to equity shareholders	–	–

During 2007, profit before tax included negative policyholder interests volatility of £233 million, being a charge to other income (2006: positive volatility of £326 million, being a charge of £33 million to net interest income and a credit of £359 million to other income). In 2007, substantial policyholder tax losses have been generated as a result of a fall in property, gilt and bond values. These losses reduce future policyholder tax liabilities and have led to a policyholder tax credit during the year. Profits were recognised in 2006 as a result of positive market movements combined with realised gains in the holdings in property investment vehicles majority owned by the long-term assurance funds.

Regulation

In the UK and elsewhere, there is continuing political and regulatory scrutiny of financial services. On 6 November 2007 the Competition Commission published its emerging thinking into the Payments Protection Inquiry and is expected to report by December 2008. The OFT is also carrying out a market study into personal current account pricing alongside its investigation into certain current account charges which are also subject to a legal test case. The OFT is also investigating interchange fees charged by some card networks in parallel with the European Commission's own investigation into cross-border interchange fees. At the same time regulators are considering the review of retail distribution and UK financial stability and depositor protection proposals. It is not presently possible to assess the cost or income impact of these inquiries or any connected matters on the Group until the outcome is known.

In addition, a number of EU directives, including the Unfair Commercial Practices Directive and Payment Services Directive are currently being implemented in the UK. The EU is also considering regulatory proposals for, inter alia, a Consumer Credit, Mortgage Credit, Single European Payments Area, Retail Financial Services Review and capital adequacy requirements for insurance companies (Solvency II). In the US, a major focus of governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with US economic sanctions, with serious legal and reputational consequences for any failures arising in these areas.

Our people

At Lloyds TSB, people are our most valuable resource. Managing our people effectively is fundamental to the success of the business and achieving our vision of being the best financial services organisation in the UK. Creating a great place to work is a core priority of the people strategy which seeks to enable Lloyds TSB to be recognised, both within the financial services sector, but also more generally in the UK employment market, as the best company to work for.

In creating a great place to work in this way, we believe we will attract the highest performing people to join us and secure the motivation and commitment of those who are the strongest performers and have the highest potential to stay.

To achieve these goals we aim to create a high commitment, high performance organisation. We are clear about what we expect from our people. Our values guide us in all our dealings with colleagues, customers and the wider community. We have nearly 70,000 people working for the Company and whilst business units across the Group have developed values specific to their business needs. They are based on the core Group values of:

- putting customers first;
- acting with integrity and respect;
- taking personal responsibility;
- working as a team.

Talent, recruitment and retention

One of the highest people priorities for our leaders is recruitment, retention and development of talented people. Top performers are attracted to join Lloyds TSB because of our reputation, strong brand and values; together with top class reward and development. Last year, we successfully recruited over 9,500 people from the external market.

It's not just about bringing in new people. Developing existing employees and succession planning are equally important to support our growth strategy. We have strong succession and development plans for all our senior leaders across the Group and we are retaining people for an average tenure across our business of 13 years.

Alongside this we run a wide range of generalist and specialist development programmes to support career progression into management. In 2007 we recruited 106 people into our business specialist programmes (A level entry), 88 people to graduate trainee programmes, offered 32 internships and 111 student placements. We are consistently identified in The Times Top 100 organisations for graduate recruitment. We also ran numerous programmes at more senior levels in management and leadership to develop our pipeline of leaders for the future.

We actively track and manage retention of our highest performers, retaining approximately 96 per cent of our top performers in 2007. In addition we have robust systems for differentiating performance and the management of under performance.

Performance management

The Group uses a balanced scorecard to measure and manage employee performance. The scorecard takes into account the needs of customers, employees and shareholders and measures individual performance against a range of factors, including financial success, contribution to the long term growth of the business, customer service, risk management and personal development.

Meeting our customers' needs is key to our business strategy. Our balanced scorecard aims to show employees how their actions impact their colleagues and customers and how this, in turn, translates into our overall performance. It ensures that people understand how their personal objectives relate to our strategy, and how their performance contributes to the Group's performance.

All employees receive formal reviews and feedback on performance at least twice a year.

Reward and recognition

We believe an individual's reward should reflect their whole contribution to the Company's achievements and take account of performance against individual objectives; contribution in terms of knowledge, competencies and skills and the level of stretch and challenge presented by objectives. In addition it will reflect their potential to develop into more senior roles.

Total reward

As well as our competitive salary packages we differentiate our reward through bonus schemes, and various reward and incentive programmes. This helps drive a high commitment, high performance culture where individuals strive for stretching goals.

We also offer an award winning flexible benefits package where eligible employees receive an additional 4 per cent of their salary each month to select from a range of benefits. Some 67 per cent of our employees currently participate in this scheme choosing from a range of non-cash alternatives including: medical and life assurance, dental plan, additional pension, holiday trading, education vouchers, childcare vouchers and matched learning.

In addition all eligible employees are entitled to participate in our various employee share plans and receive free shares which are awarded annually. For 2007 this award was 3 per cent of salary. 98 per cent of Lloyds TSB employees held free shares as at the end of 2007.

Recognition

Recognition and reward schemes are widely used throughout the organisation to celebrate team and individual achievement. While our emphasis is on providing recognition through line management, we also formally recognise those who have exceeded expectations and pushed boundaries in areas such as colleague support, customer service and building community profile.

Learning and development

We remain committed to investing in our people through providing efficient and effective learning and development that helps our people to deliver great service and achieve great results. Our focus remains on providing our people with the knowledge and skills they need for their jobs today while continuing to develop the capabilities we will need to be successful in the future.

Creating an enabling environment in which our people feel they have the right tools to develop their capabilities, perform effectively and drive business performance is key. Our learning framework enables employees to develop a clear learning plan that reflects their specific learning and future career needs.

University for Lloyds TSB

The University for Lloyds TSB, (UfLTSB), one of the largest corporate universities in Europe, delivers learning programmes through a range of media. This includes on-line knowledge modules and face to face workshops to support skills development. In 2007 the website, which acts as a primary portal for learning across the Group, received over 3 million visits and hosted almost 300,000 on line assessments.

Overall investment in people development has risen by 10 per cent in 2007, and we now deliver an average of 2.3 days formal learning per full time employee (FTE), an increase of 24 per cent on 2006. We continue to provide our people with a range of opportunities and have seen formal learning delivery increase during 2007 to 939,000 hours; an increase of 37 per cent over 2006.

In addition to developing programmes internally the UfLTSB works with external companies to develop and deliver learning. Some programmes may be certificated by external organisations providing employees with performance benchmarks and portable qualifications. We also support a range of business focused and developmental professional qualifications; for example over 1,800 people received financial study support during the year.

Lloyds TSB remains committed to the principles of Investors in People, a standard for ensuring employees have the opportunity to reach their full potential.

Training days

	2007	2006
Number of days formal learning per FTE	2.3	1.8

Employee engagement

Lloyds TSB has inspirational leaders who provide a clear direction for the organisation through our strategy and vision and values framework. The success of our vision is in its simplicity, clarity and re-enforcement in what our leaders do. We ensure our people are actively engaged through communication and participation in regular employee engagement surveys.

Communications

To support this, the Group invests in a range of internal media, ensuring our people are informed and involved. These include a company intranet, print publications and increasingly e-zines and social networking technology. The essential communication relationship between managers and their teams is also supported with bespoke communications training.

Employee engagement survey

Every quarter a comprehensive confidential employee survey is undertaken on-line to gauge employees viewpoints on key engagement issues. Our group chief executive personally agrees the content of our employee engagement survey, demonstrating our commitment and investment in understanding our employee's view. Over the last three years the overall employee engagement index has increased to 75.3 per cent and response rates have been consistently above 70 per cent.

Engagement index

	2007	2006	2005
Employee engagement index*	75.3	74.5	73.3

* The employee engagement index is based on the results of a survey conducted quarterly, asking Lloyds TSB employees a series of questions which reflect both the drivers and outcomes of engagement. The data captures the percentage of total responses received which were favourable for each question, combined into a simple average overall score.

Work environment

Lloyds TSB Group is committed to making sure the work place is maintained to the highest standards of health, safety and fire protection. Our objective is to provide great facilities and a safe environment for everyone, employees and customers alike, in all of our business locations.

Flexible working is increasingly important in the competitive workplace and we have created a balanced environment where we offer a multitude of flexible working practices including:

- reduced hours;
- variable hours;
- job sharing;
- compressed hours;
- term-time working;
- tele-working.

We believe that by treating our employees as adults and placing value on their contribution and delivery rather than working hours will create a high commitment high performance organisation.

Lloyds TSB also has a whistle blowing policy setting out the procedure by which people can raise, in confidence, any matters of concern. A whistle blowing line enables employees to raise any concerns and for such matters to be independently investigated.

Equality and diversity

Equality and diversity is not just about complying with equality legislation. We believe that it is vital for achieving competitive advantage and in a tight employment market, we need to attract and retain talented people from all the UK's diverse communities. We need to be close to our customers and provide them with the right products and services. By attracting and retaining a diverse workforce, we will better understand the needs of all our customers and be able to build lasting relationships.

Over the last few years we have been working to increase the number of women and ethnic minority employees in management and senior management positions across the organisation. At the end of 2007, there were four women on our group executive committee, one of the highest numbers for a FTSE 100 company, and 22 per cent of our senior managers were women.

We continue to make significant progress with our disability and sexual orientation programmes. In 2007 our disability programme was ranked first out of 116 organisations by the Employers' Forum on Disability and we maintained our sixth place ranking in Stonewall's† Index of the 100 best employers of lesbian, gay and bisexual people.

† Stonewall is a campaigning organisation that works to achieve equality and justice for lesbians, gay men and bisexual people.

Diversity

	2007	2006	2005
Women managers	40.1%	38.5%	38.4%
Women senior managers	21.7%	20.9%	20.3%
Ethnic minority managers††	4.9%	4.3%	4.1%
Ethnic minority senior managers††	2.5%	1.9%	1.8%
Disabled employees††	2%	1.5%	1.5%
Lesbian, gay and bisexual (LGB) employees††	0.8%	0.2%	0.2%

†† Shows percentage of whole workforce although not all employees have supplied information on race, disability or sexual orientation.

Corporate responsibility

Supporting business strategy

In an increasingly competitive market where customers are able to exercise choice among providers, we believe that shareholder value creation is closely linked to customer value creation. It is only by meeting our customers' needs that we will win the right to a bigger share of their total financial services spend.

We believe that corporate responsibility, built around the creation of employee motivation, customer satisfaction and brand loyalty, has a major part to play in supporting our business strategy. Our commitment to corporate responsibility helps promote trust in the Lloyds TSB brand and reinforces customer loyalty and advocacy. This supports our customer-orientated strategy where we look to develop our business based on deep relationships, as opposed to a product-led approach favoured by others.

Lloyds TSB is rooted in local communities throughout the UK and we take our responsibilities to those communities very seriously. By investing in the communities where we operate we not only create economic value but also make a positive social contribution. Through the Lloyds TSB Foundations, one per cent of the Group's pre-tax profits, averaged over three years, is distributed to local charities.

Our corporate vision is to make Lloyds TSB the best financial services company in the UK. Our corporate responsibility strategy is to support our corporate vision by helping to build a great place for our people to work, a great place for our customers to do business, and generating great returns for our shareholders. In so-doing, we create value for all our stakeholders through:

- more effective risk management;
- increased employee engagement;
- increased customer satisfaction;
- delivering competitive advantage through better corporate responsibility management.

All employees have a balanced scorecard of objectives that takes account of the needs of customers, employees and shareholders, rather than pure financial measures.

Managing corporate responsibility

The board reviews overall corporate responsibility performance annually and the chairman receives a quarterly progress report. Individual issues are subject to board discussion throughout the year. Our corporate responsibility steering group is chaired by the deputy group chief executive and comprises senior executives from all business divisions and relevant group functions. The steering group meets quarterly to recommend strategy and provide direction.

We have adopted the European Foundation of Quality Management's Corporate Responsibility Framework to help us align corporate responsibility with business strategy and also with individual balanced scorecard priorities. As part of the process we have a network of approximately 60 representatives across all business divisions, through whom we conduct an annual self assessment of our performance with independent oversight and assurance. This allows us to identify strengths and areas for improvement and to prioritise actions and objectives. It also provides a benchmark against which we can compare our performance both internally and externally.

The board is satisfied that the systems in place to manage corporate responsibility risks are effective and that the relevant risks have been assessed during 2007 and managed in compliance with relevant policies and procedures.

Our approach to corporate responsibility focuses on five areas; our people (see pages 32-33), our customers, our suppliers, our community and the environment.

Our customers

We want to build a great organisation, which is recognised for operating to high standards and is built on strong customer franchises. Our ultimate goal is to become Britain's most recommended bank. We have put in place the essential building blocks; providing excellent customer service from well-trained staff; appropriate products that meet real needs; treating customers fairly at all times; and following ethical business practices to build a sustainable, profitable business.

Responsible lending

We are committed to being a responsible lender. It is in our interest to help customers borrow only those amounts they can manage to repay. We have a responsible lending programme with internal management reporting and accountability. Our employees are trained to offer the necessary advice and support to help customers manage their borrowing. Our Customer Support Unit provides help for customers who are in financial difficulties to find an appropriate solution through effective budgeting or rescheduling their borrowing. We also support independent money advice networks including the Money Advice Trust and the Consumer Credit Counselling Service. Payments totalling more than £3.4 million were made in 2007.

Complaints resolved within 8 Weeks

2007	2006	2005
97.0%	94.8%	86.0%

Combating financial crime

We take protecting our customers and their assets extremely seriously and continue to invest in systems and activities to deter, detect and prevent fraud. These include transaction monitoring tools to identify suspicious account activity and the introduction of verification technology on our counters to secure withdrawals. We also work to ensure customers are aware of how to protect themselves including dedicating a section of our website to information on common internet fraud types and an annual campaign to raise awareness of the threat of identity theft.

Financial inclusion

We continue to develop financial services especially tailored to tackle the problem of financial exclusion. These include basic bank accounts, support for community credit unions and other community finance initiatives and, loan and venture capital funds, which offer loans to individuals and businesses in some of the most deprived areas in the UK. Lloyds TSB currently has £14 million invested in the community finance sector in addition to its normal commercial lending to small businesses in these areas. Our alliance with the Post Office allows our customers access to the UK network of post offices as well as over 2,000 of our own branches and over 4,100 free ATMs. At the end of 2007 we had over 470,000 basic bank accounts.

Lloyds TSB welcomes and fully supports the Financial Services Authority's initiatives to increase Financial Capability in the UK. We have seconded a Senior Executive to develop, launch and manage the financial capability in the workplace workstream of the FSA Strategy. Since launching 18 months ago, the team have provided educational material and training to over 1.2 million employees throughout the UK, and are well on track to reach the target of 4 million, by 2011. Feedback from all parties has been very encouraging and is improving these employees' financial capability.

Customer satisfaction

We measure our customers' satisfaction with the service they receive via monthly surveys and use the results to calculate our CARE Index which is based on customer understanding, accessibility, responsibility and expertise. We seek to address customer complaints as quickly as prudent while ensuring appropriate standards of investigation and communication are maintained.

Customer service index

2007	2006	2005
70.5%	69.7%	68.0%

From 2008 we will be introducing a new measure of customer advocacy, the Net Promoter Score, which measures the likelihood of customers recommending Lloyds TSB to friends, family and colleagues.

In a poll of finance directors across the UK, Lloyds TSB Corporate was voted 'Bank of the Year' for the third year running at the Real Finance/CBI FDs' Excellence Awards, in recognition of our quality of service and understanding of our customers' businesses. Lloyds TSB was also voted the Reader's Digest most trusted bank or building society for the seventh successive year in 2007.

Our suppliers

Each year we buy around £2 billion worth of goods and services. Our suppliers are important to us and we want to ensure that we treat them fairly and pay them on time. Our supplier relationships are governed by a strict Code of Purchasing Ethics that defines the way we do business. We also have an established supplier review process that allows us to assess our suppliers' social, ethical and environmental performance as part of the tendering process.

We are currently working with a number of other financial services companies to develop an industry-wide corporate responsibility questionnaire, which will include new questions on carbon management and diversity. The new questionnaire will be available on-line in 2008 and will benefit suppliers who will only have to complete one questionnaire for all participating financial services companies, as well as benefiting Lloyds TSB by providing comparable information across different suppliers.

Payment of suppliers

	2007	2006	2005	2004
Number of supplier payments	320,579	344,422	379,613	360,257
Value	£2.20 billion	£2.29 billion	£2.16 billion	£2.20 billion
Average time to pay	28.78 days	29.72 days	27.01 days	28.02 days
Number/amount of compensation payments	No payments for late settlement	No payments for late settlement	No payments for late settlement	1 payment totalling £25 for late settlement

Our community

Continuing to grow a successful business is the best way for Lloyds TSB to create value for all its stakeholders and contribute to the wider economy. We are a major employer with nearly 70,000 employees. In 2007, salaries, national insurance, pension contributions and other staff costs totalled over £2.90 billion. £0.86 billion of corporation tax was paid to governments and £1.96 billion was distributed to shareholders in the form of dividends.

In addition to our financial contribution we recognise that it is in our long-term interest to help improve the social and commercial fabric of local communities where we operate. That is why we have one of the largest community investment programmes in the UK.

Lloyds TSB Foundations

The majority of Lloyds TSB's charitable giving is channelled through the four Lloyds TSB Foundations, which cover England and Wales, Scotland, Northern Ireland and the Channel Islands. Their mission is to improve the lives of people in local communities, especially those who are disadvantaged.

Through their shares in the Lloyds TSB Group, the Lloyds TSB Foundations together receive one per cent of the Group's pre-tax profits, averaged over three years, in lieu of their shareholder dividend. In 2007 we gave £37 million to support their work and a further £37 million will be donated in 2008 bringing our total contributions since the Lloyds TSB merger to over £360 million, making Lloyds TSB one of the largest charitable donors in the UK.

The Foundations recognise that their success as community and local funders depends on maintaining a presence in and actively engaging with communities. The England and Wales Foundation, for example, remains one of the few grant-makers with a significant regional presence and its regional structure enables the Foundation to respond directly and effectively to local needs.

Foundation funding supports charities working to meet social and community needs. The main grants programmes are designed to address essential community needs and in particular, to support small under-funded charities. 41 per cent of the charities supported by the England and Wales Foundation in 2007 had a total income of £100,000 or less and 88 per cent had an income of £500,000 or less.

Employee volunteering and fundraising

In addition to the Foundations' support for local community causes, thousands of our employees volunteer to help in their communities, raise funds for the Group's Charity of the Year or make direct donations to charity using the UK's Give As You Earn system. In 2007, the Foundations provided matched funding for over 33,000 hours of time volunteered by Lloyds TSB employees in the community and also matched over £768,000 funds raised by employees for charities.

The Charity of the Year is chosen in an open ballot of staff. A team of Charity Champions across all parts of the Group leads the fundraising, inspiring and motivating their colleagues to organise and take part in events, sell pin badges and find new and innovative ways of raising money. In 2006 our staff raised over £2 million for Breast Cancer Care. Barnardo's is our current charity partner and to date almost £1 million has been raised with fundraising initiatives continuing into 2008.

The environment

Lloyds TSB first introduced a formal environmental policy in 1996 and was also one of the first UK banks to develop an environmental risk assessment system for all of our business lending.

Climate change

The UK Government has stated its belief that climate change is the greatest long-term challenge facing the world today. Measures to tackle climate change will have potential implications for regulation, taxation and public policy and will carry both risks and opportunities for companies and the public.

While our direct carbon intensity is relatively low compared to other industry sectors, we still need to fully understand the potential financial impact of climate change on others that we may lend to or invest in, so that we can manage the risks and identify business opportunities.

During 2007 we consulted with senior management across all Lloyds TSB Group businesses to identify key climate-related risks and opportunities and to develop a programme to engage our employees and customers on the environment. Following the consultation, we published a target to reduce our CO_2 emissions by 30 per cent by 2012, based on 2002 levels. This is a stretching target and to achieve it we will need to manage our energy consumption and efficiency together with our business travel.

We have established a carbon reduction committee (reporting to the corporate responsibility steering group) to measure, monitor and manage progress against the target. Environmental impacts associated with major projects are calculated and that has helped us to identify a number of property and IT related projects that will begin to deliver significant CO_2 reductions from 2008. Over time, many of these will also deliver significant cost savings.

Of course, we cannot eliminate all CO_2 emissions so in 2007 we also committed to become carbon neutral by offsetting those emissions that we cannot reduce. We can confirm that in 2007 we purchased carbon credits through our carbon trading desk to achieve carbon neutrality.

Since 2006 we have purchased part of our electricity from combined heat and power (CHP) sources, which have a lower carbon footprint than standard grid electricity. Some contracts for green electricity and CHP will expire before 2012 so progress towards the long-term target may fluctuate. We will therefore continue to concentrate on reducing our energy consumption and unnecessary business travel. The CHP figures for 2006 were not included in our 2006 report as we were still awaiting confirmation of their treatment from DEFRA at the time of reporting.

Our staff have responded enthusiastically to the challenge and are keen to be involved in environmental initiatives. We are introducing a Group wide sustainability network in 2008 for employees at all levels to meet, share experiences and ideas, and to help fulfil our commitment to reducing our carbon footprint.

Greenhouse gas emissions

Tonnes CO_2	2007	2006*	2005	2002 Baseline
Property	180,526	181,086	177,047	198,950
Property renewable	(18,164)	(18,944)	(14,606)	n/a
Travel	30,474	29,705	29,540	26,333
Total	192,836	191,847	191,981	225,283
Combined heat and power	(31,635)	(30,945)	n/a	n/a
Net total	161,201	160,902	191,981	225,283

* 2006 travel figures have been restated to reflect the fact that C&G travel data is now included and to provide a more accurate comparison between 2006 and 2007.

More information on all the above issues is available in the Group's corporate responsibility report and there are details on how to obtain a copy on page 159.

Risk as a strategic differentiator

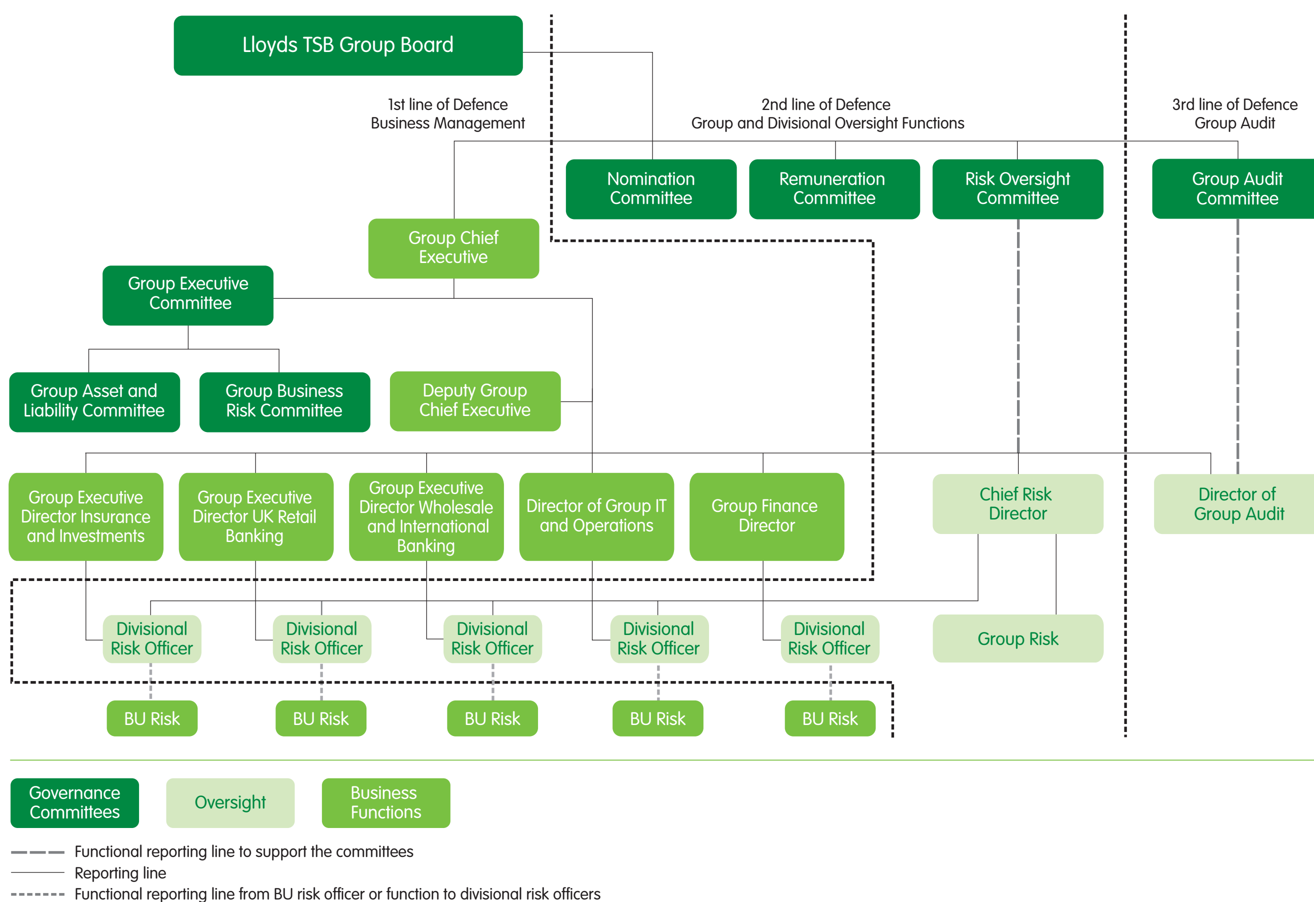
The Group seeks to optimise performance by allowing divisions and business units to operate within capital and risk parameters and the Group's policy framework. They must do so in a way which is consistent with realising the Group's strategy and meets agreed business performance targets. The Group's approach to risk management seeks to ensure the business remains accountable for risk whilst also ensuring there is effective independent oversight.

During 2007, we have continued to focus on enhancing our capabilities in providing both qualitative and quantitative data to the board on risks associated with strategic objectives and facilitating more informed and effective decision making. The Group's ability to take risks which are well understood, consistent with our strategy and plans and appropriately remunerated, is a key driver of shareholder return.

The maintenance of a strong control framework remains a priority and is the foundation for the delivery of effective risk management. Risk analysis and reporting capabilities support the identification of opportunities as well as risks and it provides an aggregate view of the overall risk portfolio. Responsibilities and timescales at group and divisional level are clearly assigned for risk mitigation strategies. Risk continues to be a key component of routine management information reporting and is embedded within staff objectives via balanced scorecards.

Risk governance structures

The Group maintains a risk governance structure that strengthens risk evaluation and management, whilst also positioning the Group to manage the changing regulatory environment in an efficient and effective manner.



Board and committees

The board, assisted by its committees, the risk oversight committee, the group executive committee, and the group audit committee, approves the Group's overall risk management framework. The board also reviews the Group's aggregate risk exposures and concentrations of risk to seek to ensure that these are consistent with the board's appetite for risk. The role of the board, audit committee and risk oversight committee are shown in the corporate governance section on pages 61 and 62, and further key risk oversight roles are described on the next page.

The group executive committee, assisted by the group business risk committee and the group asset and liability committee, supports the group chief executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, whilst also reviewing the Group's aggregate risk exposures and concentrations of risk. The group executive committee's duties are described in greater detail on page 62. The group executive committee members are also members of the group business risk committee which is chaired by the group chief executive. The group asset and liability committee, which is chaired by the deputy group chief executive, includes members of the group executive committee as well as the heads of products and markets and group market risk. The group business risk committee is supported by the following:

– Compliance and Operational Risk Committee

– Group Credit Risk Committee

– Group Change Management Committee

These committees are further supported by a number of specialist risk committees covering the Group's risk types in detail.

Group executive directors have primary responsibility for measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group's high level policies and within the parameters set by the board, group executive committee and group risk. Compliance with policies and parameters is overseen by the risk oversight committee, the group business risk committee, the group asset and liability committee, group risk and the divisional risk officers.

Reflecting the importance the Group places on risk management, risk is one of the five principal criteria that it includes within its balanced scorecard on which individual staff performance is judged. Business executives have specified risk management objectives, and incentive schemes take account of performance against these.

Risk management oversight

The chief risk director, a member of the group executive committee and reporting directly to the group chief executive, oversees and promotes the development and implementation of a consistent group wide risk management framework. The chief risk director, supported by group risk, provides objective challenge to the Group's senior management.

Divisional risk officers provide oversight of risk management activity within each of the Group's divisions. Reporting directly to the group executive directors responsible for the divisions and the chief risk director, their day-to-day contact with business management, business operations and risk initiatives seeks to provide an effective risk oversight mechanism.

The director of group audit provides the required independent assurance to the audit committee and the board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group audit is fully independent of group risk, seeking to ensure objective challenge to the effectiveness of the risk governance framework.

Business risk management

Line management are directly accountable for the management of risks arising from the Group's business. A key objective is to ensure that business decisions strike an appropriate balance between risk and reward, consistent with the Group's risk appetite. The senior executive team and board receive regular briefings and guidance from the chief risk director to ensure awareness of the overarching risk management framework and a clear understanding of their accountabilities for risk and internal control.

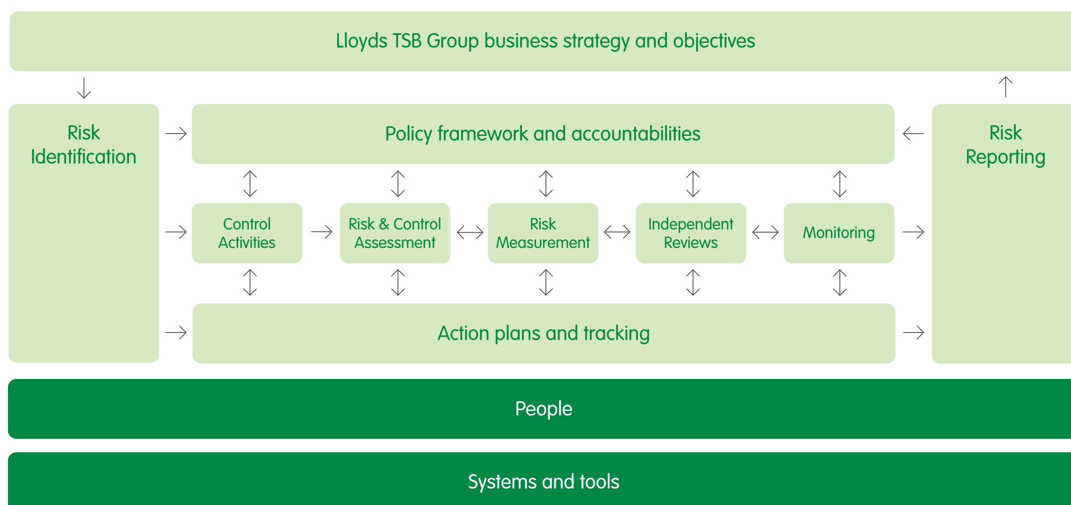
All business units, divisions and group functions complete a control self-assessment annually (described on page 63), reviewing the effectiveness of their internal controls and putting in place enhancements where appropriate. Managing directors and group executive directors certify the accuracy of their assessment.

Business risk management forms part of a tiered risk management model, as shown on page 36 with the divisional risk officers providing oversight and challenge, as described above, and the chief risk director and group committees establishing the group wide perspective.

This approach seeks to provide 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 facilitates effective communication on these matters across the Group.

Risk management framework

The Group uses an enterprise-wide risk management framework for the identification, assessment, measurement and management of risk, designed to meet its customers' needs. It seeks to maximise value for shareholders over time by aligning risk management with the corporate strategy, assessing the impact of emerging risks from legislation, new technologies or the market, and developing risk tolerances and mitigating strategies. The framework strengthens the Group's ability to identify and assess risks; aggregate group wide risks and define the corporate risk appetite; develop solutions for reducing or transferring risk, where appropriate; and exploit risks to gain competitive advantage, thereby seeking to increase shareholder value. The principal elements of the risk management framework are shown below:



The risk management framework above comprises 10 interdependent activities which map to the components of the internal control-integrated framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO).

Lloyds TSB Group business strategy and the desired outcomes for our key stakeholders are used to determine the Group's high level risk principles and risk appetite measures and metrics for the primary risk types. A key focus in 2007 has been to develop earnings volatility measures to complement existing capital measures for risk appetite. Risk appetite is reviewed annually in line with the overall Group's appetite and the reward potential of the relevant exposures. Risk appetite is defined, cascaded and monitored.

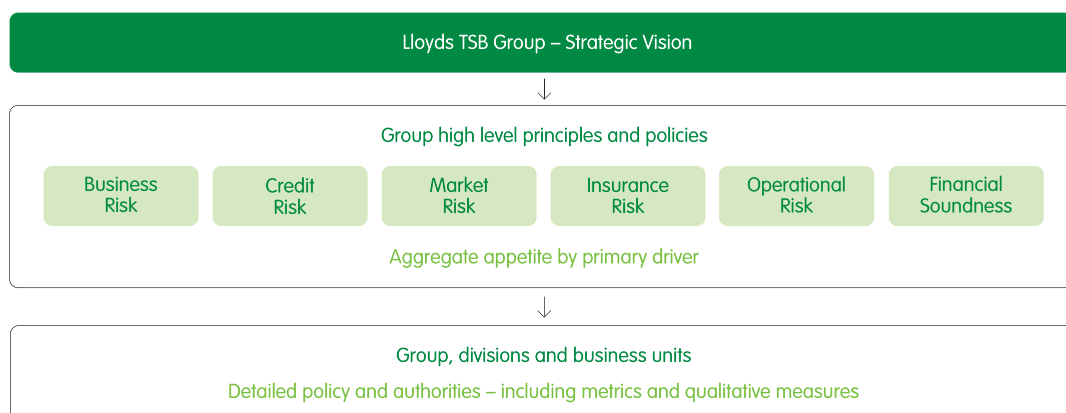
Group, divisions and business units ensure that there is a process for **risk identification** of the exposure to each risk type.

The risk appetite is proposed by the group chief executive and reviewed by various governance bodies including the group executive committee and the risk oversight committee. Responsibility for the approval of risk appetite rests with the board. The approved high level appetite and limits are delegated to individual group executive directors by the group chief executive.

The more detailed articulation of the risk principles and distribution of the risk appetite measures amongst the divisions and businesses are subsequently determined by the group chief executive, through consultation with the group business risk committee.

A key component of the risk management framework is the **policy framework and accountabilities**. The main policy levels are identified below:

- Principles – high level principles for the six primary risk drivers
- High level group policy – policy for the main risk types aligned to the risk drivers
- Detailed group policy – detailed policy that applies across the Group
- Divisional policy – local policy that specifically applies to a division
- Business unit policy – local policy that specifically applies to a business unit



Divisional and business unit policy is only produced by exception and is not necessary unless there is a specific area for which a particular division or business unit requires a greater level of detail than is appropriate for group level policy. The governance arrangements for development of, and compliance with, group, divisional and business unit policy and the associated accountabilities are clearly outlined. All staff are expected to be aware of the policies and procedures which apply to them and their work and to observe the relevant policies and procedures. Line management in each business area has primary responsibility for ensuring that group policies and the relevant local policies and procedures are known and observed by all staff within that area.

Group and divisional risk functions have responsibility for overseeing effective implementation of policy. Group audit provides independent assurance to the board about the effectiveness of the Group's control framework and adherence to policy. Policies are reviewed at least annually to seek to ensure they remain fit for purpose.

Proportionate **control activity** strategy is put in place to design mitigating controls, to transfer risk where appropriate and to ensure executives are content with the residual level of risk accepted.

Risk and control assessments are undertaken to assess the effectiveness of current mitigations and whether risks taken are consistent with the Group's risk appetite (this includes the annual control self assessment exercise).

The impact of risks and issues (including financial, reputational and regulatory capital) are determined through effective **risk measurement** including modelling and stress testing.

The outcomes of **independent reviews** (including internal and external audit and regulatory reviews) are integrated into risk management activities and action plans.

Risk reporting is standardised through the use of consistent definitions when reporting, to enable risk aggregation. Divisions monitor their risk levels against their risk appetite seeking to ensure effective mitigating action has been taken where appropriate. Divisional risk reports are reviewed by divisional executive committees to ensure that respective senior management are satisfied with the overall risk profile, risk accountabilities and progress on any necessary mitigating actions. Reporting, including that of performance against relevant limits or policies, is in place at a detailed level appropriate to the exposures concerned and regular information is provided to group risk for review and aggregate reporting. Any significant issues identified in the **monitoring** process are appropriately reported, and an escalation process is in place to report significant losses to appropriate levels of management. Group risk reports on risk exposures and material issues quarterly to the group asset and liability committee, group business risk committee, group executive committee, risk oversight committee and the board.

At group level a consolidated risk report is produced which is reviewed and debated by the group business risk committee, group executive committee, risk oversight committee and the board to ensure senior management and the board are satisfied with the overall risk profile, risk accountabilities and mitigating actions. During the year the Group's consolidated risk report was further enhanced to support the ongoing identification, control and effective management of risk.

Risk drivers

The Group's risk language is designed to capture the Group's principal risks referred to as the 'primary risk drivers'. A description of each risk, including definition, appetite, control and exposures is included in the detail to this report. These are further broken down into 25 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out below.

Through the Group's risk management processes these risks are assessed on an ongoing basis to ensure optimisation of risk and reward and that, where required, appropriate mitigation is in place. Both quantitative and qualitative factors are considered in assessing the Group's current and potential future risks.

Primary risk drivers	Business Risk	Credit Risk	Market Risk	Insurance Risk	Operational Risk	Financial Soundness
Detailed risk types	Strategy setting Execution of strategy	Retail Wholesale	Interest rate Foreign exchange Equity Credit spread	Mortality Longevity Morbidity Persistency	Legal and regulatory Customer treatment Products and services Process and resource Theft, fraud and other criminal acts People Change Governance	Liquidity and funding Capital Financial and prudential regulatory reporting Disclosure Tax

Principal risks

At present the most significant risks faced by the Group are:

- Legal and regulatory risk, reflecting the legal and regulatory environment in which the Group operates and the volume and pace of change from within the UK and the rest of the world. This impacts the Group, both operationally in terms of cost of compliance with uncertainty about legal and regulatory expectations, and strategically through pressure on key earnings streams. The latter could potentially result in changes to business and pricing models, particularly in the UK retail market. Our business planning processes continue to reflect change to the legal and regulatory environment. Major current legal and regulatory reviews and proceedings are described on page 31. In addition, the Group faces risk where legal proceedings are brought against it. Regardless of whether such claims have merit, the outcome of legal proceedings is inherently uncertain and could result in financial loss.
- Credit risk, reflecting the risk inherent in our lending businesses. In unsecured retail credit, lending criteria and limits have been tightened further during the year and collections and recoveries processes enhanced. Wholesale credit markets remain volatile and dislocated. This market dislocation is beginning to impact the real economy, where fears of a credit crunch persist. This could result in a significant worsening of the business environment.
- Market risk arising in Insurance and Investments division and the Group's pension schemes, reflecting the exposure to a fall in equity markets and the consequent effect upon the value of assets held by either the insurance businesses or in the pension schemes. The value of the pension schemes liabilities is also exposed to changes in real interest rates. Both of these market risks could impact earnings adversely.
- Insurance risk arising in Insurance and Investments division and the Group's pension schemes reflecting the exposure to increasing longevity of annuitants and pensioners.

The current dislocation in global capital markets has been the most severe examination of the banking system's capacity to absorb sudden significant changes in the funding and liquidity environment in recent history and individual institutions have faced varying degrees of stress. Should the Group be unable to continue to source a sustainable funding profile which can absorb these sudden shocks, it could impact its ability to fund its financial obligations or could result in securing them at an excessive cost. Throughout the market dislocation, the Group has maintained a strong liquidity position based on its significant retail and corporate deposit base.

Business risk

Definition

Business risk is defined as the risk to economic profit in the Group's budget and over the medium term plan arising from a sub optimal business strategy, or the sub optimal implementation of the plan as agreed by the board of directors. In assessing business risk consideration is given to internal and external factors.

Risk appetite

Business risk appetite is encapsulated in the Group's budget and medium-term plan, which are sanctioned by the board on an annual basis. Divisions and business units subsequently align their plans to the Group's overall business risk appetite.

Exposures

The Group's portfolio of businesses exposes it to a number of internal and external factors:

- internal factors: resource capability and availability, customer treatment, service level agreements, products and funding and the risk appetite of other risk categories; and
- external factors: economic, technological, political, social and ethical, environmental, legal and regulatory, market expectations, reputation and competitive behaviour.

Measurement

An annual business planning process is conducted at group and business unit level which includes a quantitative and qualitative assessment of the risks that could impact the Group's plans. Within the planning round, the Group conducts both scenario analysis and stress tests to assess risks to future earning streams. Over the last few years, the Group has made significant progress with embedding stress testing and scenario analysis into its risk management practice with the dual objectives of adding value to the business whilst also meeting regulatory requirements. The Group assesses a wide array of scenarios including economic recessions, regulatory action scenarios, pandemics and scenarios specific to the operations of each part of the business.

A common approach is applied across the Group to assess the creation of shareholder value. This is measured by economic profit (the profit attributable to shareholders, less a notional charge for the equity invested in the business). The focus on economic profit allows the Group to compare the returns being made on capital employed in each business on a consistent basis.

Mitigation

As part of the annual business planning process, the Group develops a set of management actions to prevent or mitigate the impact on earnings in the event that business risks materialise. Additionally, business risk monitoring, through regular reports and oversight, results in corrective actions to plans and reductions in exposures where necessary.

Revenue and capital investment decisions require additional formal assessment and approval. Formal risk assessment is conducted as part of the financial approval process. Significant mergers and acquisitions by business units require specific approval by the board. In addition to the standard due diligence conducted during a merger or acquisition, group risk conducts, where appropriate, an independent risk assessment of the target company and its proposed integration into the Group.

Monitoring

The Group's strategy is reviewed and approved by the board. Regular reports are provided to the group executive committee and the board on the progress of the Group's key strategies and plans. Group risk conducts oversight to seek to ensure that business plans remain consistent with the Group's strategy.

Credit risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, as a result of the failure of the party with whom we have contracted to meet its obligations (both on and off balance sheet).

Risk appetite

Credit risk appetite is expressed both in terms of credit risk economic equity and in terms of the impact of credit risk on earnings volatility.

Credit risk appetite is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio model parameters which in turn use the various credit risk rating systems as inputs. These metrics are supplemented by a variety of policies, sector caps and limits to manage concentration risk at an acceptable level.

Exposures

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients. The credit risk exposures of the Group are set out in note 47 to the financial statements.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit can be cancelled and the credit-worthiness of customers is monitored continually. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards.

Credit risk can also arise from debt securities, derivatives and foreign exchange activities. Note 16 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2007. 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 47 on page 136.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers.

Measurement

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the 'probability of default' by the client or counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely recovery ratio on the defaulted obligations (the 'loss given default').

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. For its retail lending, exposure at default and loss given default models are also in use. All rating models, which are authorised by executive management, comply with the Group's standard methodology. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and/or credit officer judgement. Each rating model is subject to a rigorous validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible.

Each probability of default rating model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. The outputs of different rating approaches are also mapped on to either a retail or a wholesale master scale (Note 47 to the financial statements provides an analysis of the portfolio). Exposures migrate between classifications if the assessment of the obligor probability of default changes, or, in the case of mortgages, if the obligor probability of default changes or the assessment of loan-to-value changes.

The rating systems described above assess probability of default, exposure at default and loss given default, in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment (see note 19 to the consolidated financial statements on page 104). Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss model that is used for internal operational management and banking regulation purposes.

The Group's debt securities holdings, which are the subject of external agency ratings, are marked to market and independently checked by the middle office function within the products and markets business. Similarly, debt security investments within Scottish Widows are independently marked to market.

The Group also employs a statistically-based credit portfolio model, which models portfolio credit risk based on defaults and calculates the economic equity employed and credit value at risk for each portfolio.

Mitigation

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

Internal control

- Credit principles and policy: Group risk sets out the group credit principles and policy according to which credit risk is managed, which in turn is the basis for divisional and business unit credit policy. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. Credit policy also specifies maximum holding period limits for the credit trading portfolios.
- Counterparty limits: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit approval criteria for counterparty underwriting is the same as that for assets intended to be held over the period to maturity.
- Credit scoring: In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Divisional risk departments review scorecard effectiveness and approve changes, with material changes subject to group risk approval.
- Cross-border and cross-currency exposures: Country limits are authorised and managed by a dedicated unit taking into account economic and political factors.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines that reflect risk appetite. Credit policy is aligned to our risk appetite and restricts exposure to certain high risk and more vulnerable sectors. Note 18 to the accounts provides an analysis of loans and advances to customers by industry (for wholesale) and product (for retail). Exposures are monitored to prevent excessive concentration of risk. These

concentration risk controls are not necessarily in the form of a maximum limit on lending but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. Amongst these controls is a series of sector caps to manage residual value risk exposure, seeking to ensure an acceptable distribution of risk. The Group's large exposures are managed in accordance with regulatory reporting requirements.

- Stress testing and scenario analysis: The credit portfolio is also subjected to stress-testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group wide level, at divisional and business unit level and by portfolio, for example, for a specific industry sector.
- Specialist units: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector-specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- 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 counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.

Collateral

The principal collateral types for loans and advances are:

- Mortgages over residential properties;
- Charges over business assets such as premises, inventory and accounts receivable;
- Charges over financial instruments such as debt securities and equities;
- Guarantees received from third parties.

The Group has implemented guidelines on the acceptability of specific classes of collateral. Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial instruments. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement.

It is Group policy that collateral should always be realistically valued by an appropriately qualified source, independent of the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are noticed for the relevant individual loans and advances.

Master netting agreements

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), the Group enters into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are 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 it is affected by each transaction subject to the agreement.

Derivatives

Credit risk exposure on individual derivative transactions is managed as part of overall lending limits with customers, together with potential exposures from market movements. Collateral or other security is not usually obtained for credit risk exposures on these instruments, except where the Group requires margin deposits from counterparties.

Other credit risk transfers

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

Monitoring

- Portfolio monitoring and reporting: In conjunction with group risk, businesses and divisions identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Group risk in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to the group business risk committee.
- Risk assurance and oversight: Divisional and group level oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.
- Term to maturity: The Group monitors the term to maturity of credit commitments because longer-term commitments generally have a greater degree of credit risk than shorter-term commitments.

Market risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, exchange rates and prices for bonds, commodities, equities, property and other instruments. It arises in all areas of the Group's activities and is managed by a variety of different techniques.

Risk appetite

Market risk appetite is defined as the quantum and composition of market risk that exists currently in the Group and the direction in which the Group wishes to manage this.

This statement of the Group's overall appetite for market risk is reviewed and approved annually by the board. The group chief executive allocates this risk appetite across the Group. Individual members of the group executive committee ensure that market risk appetite is further delegated to an appropriate level within their areas of responsibility.

Exposures

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk.

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products. However, some interest rate and exchange rate positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Foreign currency risk also arises from the Group's investment in its overseas operations.

The Group's insurance activities also expose it to market risk, encompassing interest rate, exchange rate, property and equity risk:

- The management of with-profits funds leads to assets and liabilities that are mismatched with the aim of generating a higher rate of return on assets to meet policyholders' expectations.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets.
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in three portfolios: the surplus in the non-profit fund within the long term fund of Scottish Widows plc, assets in shareholder funds of life assurance companies and an investment portfolio within the general insurance business.

The Group's defined benefit pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to page 116.

Measurement

The primary market risk measure used within the Group is the Value at Risk (VaR) methodology, which incorporates the volatility of relevant market prices and the correlation of their movements. This is used for determining the Group's overall market risk appetite and for the high level allocation of risk appetite across the Group. Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. The use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. VaR can also be less well suited to non-linear positions, for example options. The Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures.

Banking – trading and other financial assets at fair value through profit or loss

Based on the commonly used 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2007 and 2006 based on the Group's global trading positions was as detailed in the table below (the table also aggregates potential loss measures from options portfolios). VaR is calculated daily for trading and other fair valued portfolios in the products and markets business.

The risk of loss measured by the VaR model is the potential loss in earnings. The total and average trading VaR does not assume any diversification benefit across the four risk types. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole.

	31 December 2007				31 December 2006			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	1.63	2.20	4.66	1.27	3.67	2.47	4.71	0.61
Foreign exchange risk	0.08	0.23	0.53	0.04	0.26	0.31	0.72	0.04
Equity risk	0.00	0.29	3.02	0.00	0.00	0.00	0.00	0.00
Credit spread risk	4.21	3.60	8.30	2.06	2.31	1.52	2.46	0.00
Total VaR	5.92	6.32	11.00	4.28	6.24	4.30	6.30	0.89

Banking – non-trading

The estimated impact of an immediate 200 basis point increase in interest rates on economic value for the years ended 31 December 2007 and 2006 is shown below. Economic value is defined as the present value of the non-trading portfolios concerned. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. No currency breakdown has been provided due to the relatively low overall sensitivity. These calculations are made monthly using assumptions regarding the maturity of interest rate insensitive assets and liabilities. The portfolio is updated monthly to reflect any changes in the relationship between customer behaviour and the level of interest rates. This non-trading disclosure is now value based rather than income based (as in 2006) in line with market risk reporting used internally.

Internal reporting shows this sensitivity as a percentage of the Group's regulatory capital base, and as at December 2007 the relevant percentage was 0.4 per cent (2006 2.9 per cent). The sensitivity has fallen as a result of changes to balance sheet management strategy. This is a risk based disclosure and the amounts below would be amortised in the income statement over the duration of the portfolio.

	31 December 2007 £m	31 December 2006 £m
Reduction in value	67	476

Insurance portfolios

The Group's market risk exposure in respect of insurance activities described above is measured using European Embedded Value (EEV) as a proxy for economic value. The pre-tax sensitivity of EEV to standardised market stresses is shown below for the years ended 31 December 2007 and 2006. Foreign exchange risk arises predominantly from overseas equity holdings. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile or tracked on a daily basis. This disclosure has been amended to reflect internal reporting for market risk in the insurance portfolio, in accordance with IFRS7.

	31 December 2007 £m	31 December 2006 £m
Equity risk (impact of 10% fall pre-tax)	(248)	(277)
Interest rate risk (impact of 25bp reduction pre-tax)	58	85

Mitigation

Various mitigation activities are undertaken across the Group to manage portfolios and ensure they remain within approved limits.

Banking – non-trading activities

Interest rate risk arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled.

Insurance activities

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

Monitoring

The group asset and liability committee regularly reviews high level market risk exposure including, but not limited to, the data described above. It also makes recommendations to the group chief executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by group risk. Where appropriate, escalation procedures are in place.

Banking activities

Trading is restricted to a number of specialist centres, the most important centre being the products and markets business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed within limits defined in the detailed group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Insurance activities

Market risk exposures from the insurance businesses are controlled via approved investment policies and limits set with reference to the Group's overall risk appetite and regularly reviewed by the group asset and liability committee:

- With-profits funds are managed in accordance with the relevant fund's principles and practices of financial management.
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.
- Investment strategy for surplus assets held in excess of liabilities takes account of the regulatory and internal business requirements for capital to be held to support the business now and in the future.

The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

Insurance risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

Risk appetite

Insurance risk appetite is defined as the quantum and composition of insurance risk that exists currently in the Group and the direction in which the Group wishes to manage this.

Exposures

The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk carried by the Group's pension schemes is related to mortality.

Measurement

Insurance risks are measured using a variety of techniques including stress and scenario testing; and, where appropriate, stochastic modelling.

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate.

Mitigation

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level committees/boards. For the life assurance businesses the key control body is the board of Scottish Widows Group Limited with the more significant risks also being subject to approval by the group executive committee and/or the Lloyds TSB Group board. For the general insurance businesses the key control body is the Lloyds TSB Insurance executive committee with the more significant risks again being subject to group executive committee and/or Lloyds TSB Group board approval. All group pension schemes issues are covered by the group asset and liability committee and the group business risk committee.

The overall insurance risk is mitigated through pooling and through diversification across large numbers of uncorrelated individuals, geographical areas, and different types of risk exposure.

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals would usually be priced in accordance with the underwriting assessment)
- Claims management
- Product management
- The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

Some insurance risks are retained while others are reinsured with external underwriters. The retained risk level is carefully controlled and monitored, with close attention being paid to underwriting, claims management, product design, policy wordings, adequacy of reserves, solvency management and regulatory requirements.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the probable maximum loss under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present.

In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees and that risk management is in line with the Group's risk appetite.

Monitoring

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk.

Expenses are monitored by an analysis of the Group's experience relative to budget. Reasons for any significant divergence from expectation are investigated and remedial action taken.

Persistency rates of life assurance policies, which relate to the rate of policy termination and the rate at which policies cease to pay regular premiums, are regularly assessed by reference to appropriate risk factors.

Operational risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events. There are a number of categories of operational risk:

Legal and regulatory risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from failing to comply with the laws, regulations or codes applicable.

Customer treatment risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate or poor customer treatment.

Product and service risk

The risk of loss, both financial and reputational, from the inherent design, management or distribution of products, or from the failure to meet or exceed customer expectations, competitor offerings or regulatory requirements.

Process and resource risk

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from inadequate or failed internal processes and systems, people-related events, damage to resources (excluding human resources), and deficiencies in the performance of external suppliers/service providers.

Theft, fraud and other criminal acts risk

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from frauds carried out against the Group, and/or theft of the Group's assets, and other criminal acts.

People risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate staff behaviour, industrial action or health and safety issues. Loss can also be incurred through failure to recruit, retain, train, reward and incentivise appropriately skilled staff to achieve business objectives and through failure to take appropriate action as a result of staff underperformance.

Change risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale or failing to implement change effectively or realise the desired benefits.

Governance

The risk of reductions in earnings and/or value, through financial or reputational loss, from poor corporate governance at group, divisional and business unit level. Corporate governance in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

Risk appetite

Operational risk appetite is defined as the quantum and composition of operational risk identified in the Group and the direction in which the Group wishes to manage it.

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty. In setting operational risk appetite, the Group looks at both impact on solvency and the Group's reputation, including customer service requirements.

For legal and regulatory risk the Group has minimal risk appetite and seeks to operate to high ethical standards. The Group encourages and maintains an appropriately balanced legal and regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

Exposures

The main sources of operational risk within the Group relate to uncertainties created by the changing business, in particular the legal and regulatory environment in which financial firms operate both in the UK and overseas. As a result the most significant operational risk exposures are legal and regulatory.

Legal and regulatory exposure is driven by the significant volume of current legislation and regulation with which the Group has to comply, along with new legislation and regulation which needs to be reviewed, assessed and embedded into day to day operational and business practices across the Group as a whole. Further uncertainties arise where regulations are principles based without supporting minimum standards either for the benefit of the consumer or firms. This gives rise to both the risk of retrospection from any one regulator combined with the risk of differing interpretation by individual regulators.

For legal and regulatory risks there are significant reputational risks associated with potential censure which drive the Group's stance on appetites referred to above. There are clear accountabilities and processes in place for reviewing new and changing requirements. Each business has a nominated individual with 'compliance oversight' responsibility under FSA rules. The role of such individuals is to advise and assist management to ensure that each business has a control structure which creates awareness of the rules and regulations, to which the Group is subject, and to monitor and report on adherence to these rules and regulations.

Measurement

Throughout 2007 there has been ongoing development of operational risk appetites and metrics to ensure both current and potential future operational risk exposures are understood in terms of both risk and reward potential.

The Group has a comprehensive and consistent operational risk management framework for the timely identification, measurement, monitoring and control of operational risk.

Integral to this operational risk management framework is a hybrid approach to calculating capital to support unexpected losses. The capital model calculations are driven by internal data which captures past losses, and forward looking scenarios which value potential future risk events. External industry wide data is collected to help with validating scenarios.

The capital model outputs are used to determine the internal capital charge for the Group which is then allocated to the businesses within the Group. Following review and approval of the operational risk management framework and capital model the FSA has granted the banking businesses within the Group an Advanced Measurement Approach (AMA) Waiver which recognises the embedding of the operational risk framework across the Group. The waiver allows the Group to calculate its own regulatory capital charge for operational risk from its capital model with effect from 1 January 2008.

The intention is to extend the same methodology to the insurance businesses within the Group where regulatory capital is currently determined under the ICA requirements.

Mitigation

The Group's operational risk management framework consists of five key components:

- Identification of the key operational risks facing a business area.
- Evaluation of the effectiveness of the control framework covering each of the key risks to which the business area is exposed.
- Evaluation of the non-financial exposures (e.g. reputational risk) for each of the risks to which the business area is exposed.
- For each of the material risks identified, an estimate of the exposure to financial losses that could result within the coming financial year, together with a 'worst case' stressed estimate.
- For each of the material risks identified an estimate of exposure to high impact, low frequency events through a scenario.

The Group purchases insurance to mitigate certain operational risk events.

Monitoring

Business unit risk exposure is aggregated at divisional level and reported to Group risk where a group-wide report is prepared. The report is discussed at the monthly group compliance and operational risk committee, with an extended report being reviewed once a quarter. This committee can escalate matters to the chief risk director, or higher committees if appropriate.

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.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

Financial soundness

Definition

The risk of financial failure, reputational loss, loss of earnings and/or value arising from a lack of liquidity, funding or capital, and/or the inappropriate recording, reporting and disclosure of financial, taxation and regulatory information.

Liquidity and funding

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost. Funding risk is further defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

Capital

Capital risk is defined as the risk that the group has insufficient capital to provide a stable resource to absorb any losses or that the capital structure is inefficient.

Financial and prudential regulatory reporting, disclosure and tax

The risk of reputational damage, loss of investor confidence and/or financial loss arising from, the adoption of inappropriate accounting policies, ineffective controls over financial, prudential regulatory and tax reporting and the failure to disclose information on a timely basis about the legal constitution of the Group.

Risk appetite

Financial soundness risk appetite is set and reported through various metrics that enable the Group to manage liquidity and capital constraints and shareholder expectations. It also includes the avoidance of the need for restatement of published financial and prudential regulatory reporting, disclosure and tax.

Exposure

Liquidity and funding

Liquidity exposure represents the amount of potential outflows in any future period less committed inflows in that period such that the Group is unable to meet its financial obligations as they fall due, or can only secure them at excessive cost. Liquidity is considered from both an internal and regulatory perspective.

Capital

Capital exposure arises should the Group have insufficient regulatory capital resources to support its strategic objectives and plans, and meet external stakeholder requirements and expectations.

The Group's capital management policy is focused on optimising value for shareholders. There is a clear focus on delivering organic growth and expected capital retentions are sufficient to support planned levels of growth. However, management also wishes to maintain the flexibility to make value enhancing 'in market' acquisitions and therefore, at this stage, there are no plans to return capital to shareholders other than by way of dividend payments. Management will keep all options for the utilisation of capital under review.

Financial and prudential regulatory reporting, disclosure and tax

Exposure represents the sufficiency of our policies and procedures to maintain adequate books and records to support statutory, regulatory and tax reporting, to present and detect financial reporting fraud and to manage the Group's tax exposure.

Measurement

Liquidity and funding

A series of measures are used across the Group to monitor both short and long term liquidity including ratios, cash outflow triggers and stress test survival period triggers.

An analysis of financial instrument liabilities of the Group, excluding those arising from insurance contracts, on an undiscounted future cash flow basis according to contractual maturity into relevant maturity groupings based on the remaining period at the balance sheet date is shown in note 47 to the accounts. An analysis of insurance contracts on a behavioural basis is also shown in note 47 to the accounts.

Capital

For the banking businesses the international standard for measuring capital adequacy is the risk asset ratio, which relates regulatory capital to balance sheet assets and off-balance sheet exposures weighted according to broad categories of risk as defined by the Basel I framework.

The Group's regulatory capital is divided into tiers defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA's General Prudential Sourcebook. Tier 1 comprises mainly shareholders' equity, tier 1 capital instruments and minority interests, after deducting goodwill and other intangible assets. Tier 2 comprises collective impairment provisions, and qualifying subordinated loan capital, with restrictions on the amount of collective impairment provisions and loan capital which may be included. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. Total capital is reduced by deducting investments in subsidiaries and associates which are not consolidated for regulatory purposes and investments in the capital of other credit/financial institutions. In the case of Lloyds TSB Group, this means that the net assets of its life assurance and general insurance businesses are deducted from its regulatory capital.

Risk-weighted assets are determined according to a broad categorisation of the nature of each asset or exposure and counterparty and, for the FSA defined trading book, by taking into account market-related risks.

	31 December 2007 £m	31 December 2006 £m
Capital:		
Core tier 1		
Share capital and reserves	12,141	11,155
Regulatory post-retirement benefit adjustments	704	1,041
Other items	–	39
Perpetual non-cumulative preference shares		
Preference share capital and preferred securities	1,589	1,610
Innovative tier 1		
Innovative tier 1 capital instruments*	1,474	1,372
Adjustments to tier 1		
Available-for-sale revaluation reserve and cash flow hedging reserve	402	(12)
Goodwill	(2,358)	(2,377)
Total tier 1 capital	13,952	12,828
Tier 2		
Undated loan capital	4,457	4,390
Dated loan capital	3,441	3,624
Collectively assessed provisions	2,150	1,951
Available-for-sale revaluation reserve in respect of equities	12	–
Total tier 2 capital	10,060	9,965
	24,012	22,793
Supervisory deductions		
Life and pensions businesses	(4,373)	(5,368)
Other deductions	(762)	(790)
Total supervisory deductions	(5,135)	(6,158)
Total capital	18,877	16,635

	31 December 2007 £bn	31 December 2006 £bn
Risk-weighted assets (unaudited)		
UK Retail Banking	61.7	59.1
Insurance and Investments	3.3	3.1
Wholesale and International Banking	105.1	91.8
Central group items	1.9	2.0
Total risk-weighted assets	172.0	156.0
Risk asset ratios (unaudited)		
Total tier 1	8.1%	8.2%
Total tier 1, excluding innovative capital instruments*	7.3%	7.3%
Total capital	11.0%	10.7%

*A firm is permitted to include innovative tier 1 capital in its tier 1 capital resources for the purposes of GENPRU1.2 (adequacy of financial resources) but is required to exclude these amounts from tier 1 for the purposes of meeting the main BIPRU firm Pillar 1 rules. Accordingly, the Group has provided its tier 1 capital ratio both including and excluding these amounts.

There are limits imposed by the FSA as to the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities. The unpredictable nature of movements in the value of the investments supporting the long-term assurance funds could cause the amount of qualifying tier 2 capital to be restricted because of falling tier 1 resources. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

Lloyds TSB Group and its regulated subsidiary banks have been allocated an Individual Capital Ratio by the FSA, and the board has agreed a formal buffer to be maintained in addition to this ratio. Any breaches of the formal buffer must be notified to the FSA, together with proposed remedial action. No such notifications have been made during 2007.

With effect from 1 January 2008 the Group moved onto the Basel II framework and maintained satisfactory capital ratios throughout the transition as set out in further detail on page 51.

The life assurance and general insurance businesses are subject to separate regulatory rules. Further disclosure relating to the life assurance business, as required by FRS 27, is set out in detail on pages 52 to 56.

Financial and prudential regulatory reporting, disclosure and tax

The Group has developed procedures to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite.

Mitigation

Liquidity and funding

The Group mitigates the risk of a liquidity mismatch which is outside of its appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term strategic funding.

Short-term liquidity management is considered from two perspectives; business as usual and crisis liquidity, both of which relate to funding in the less than one year time horizon.

Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as an original maturity of more than one year.

The Group's funding and liquidity management is fundamentally based on a significant retail deposit base, accompanied by appropriate funding from the wholesale markets. A substantial proportion of the retail deposit base is made up of customer's current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to provide inter-bank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on an analysis of the market's capacity for the Group's credit, based on quantitative data. The Group has developed strong relationships with certain wholesale market segments, for example central banks and corporate customers, to supplement its retail deposit base.

During 2007, amounts deposited by customers increased by £17,213 million from £139,342 million at 31 December 2006 to £156,555 million at 31 December 2007. These customer deposits were supplemented by short-term wholesale market operations, the use of sale and repurchase agreements and the issue of subordinated loan capital and wholesale funding sources in the capital markets; these comprised Euro Medium-Term Note programmes, of which £7,090 million had been utilised for senior funding at 31 December 2007, and commercial paper programmes, under which £5,051 million had been utilised at 31 December 2007. The Group also raised wholesale funding via the issuance of Residential Mortgage Backed Securities; £12,403 million was outstanding at 31 December 2007.

The ability to sell assets quickly is also an important source of liquidity for the Group's banking businesses. The Group holds sizeable balances of marketable debt securities which can be sold to provide additional short term funding should the need arise.

Within the insurance businesses, non-linked funds investments are arranged to minimise the possibility of being a distressed seller whilst at the same time investing to meet policyholder obligations. For unit-linked business, deferral provisions are designed to give time to realise linked assets without being a forced seller.

Capital

The Group is able to raise funds by issuing subordinated liabilities or equity. As at 31 December 2007, the Group had £11,958 million of subordinated debt in issuance. The cost and availability of subordinated liability finance are influenced by credit ratings. A reduction in these ratings could increase the cost and could reduce market access. At 31 December 2007, the credit ratings of Lloyds TSB Bank, the primary issuer in the Group, were as follows:

	Senior debt
Moody's	Aaa
Standard & Poor's	AA
Fitch	AA+

The ratings outlook from Moody's, Standard & Poor's and Fitch for Lloyds TSB Bank is stable. These credit ratings are not a recommendation to buy, hold or sell any security; and each rating should be evaluated independently of every other rating.

Financial and prudential regulatory reporting, disclosure and tax

The Group maintains a system of internal controls, consistently applied, providing reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements, prudential regulatory reporting and tax returns in accordance with IFRS, statutory and regulatory requirements.

Monitoring

Liquidity and funding

Liquidity is actively monitored at business unit and group level at an appropriate frequency. Routine reporting is in place to senior management and through the Group's committee structure, in particular GALCO. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the event. Liquidity policies and procedures are subject to independent oversight.

Capital

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by GALCO. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

Financial and prudential regulatory reporting, disclosure and tax

The group undertakes a programme of work designed to support an annual assessment of the effectiveness of internal controls over financial reporting, in accordance with the requirements of s.404 of the US Sarbanes-Oxley Act of 2002; to identify and maintain tax liabilities and to assess emerging regulation and legislation.

Basel II (unaudited)

The Group has placed significant focus on the implementation of Basel II. During the year the Group was successful in obtaining the FSA's approval of both its credit risk waiver application to use an Internal Ratings Based (IRB) approach for the majority of its credit portfolios (Retail IRB for retail portfolios and Foundation IRB for non-retail portfolios) and of its application to use the Advanced Measurement Approach (AMA) for operational risk. It also submitted to the FSA its Internal Capital Adequacy Assessment Process document in April 2007.

For information, a comparison of Basel I to Basel II equivalents, on the Group's key ratios as at 31 December 2007 is shown below:

	Basel I 31 December 2007 £m	Basel II 31 December 2007 £m
Capital:		
Tier 1	13,952	13,545
Tier 2	10,060	6,994
	24,012	20,539
Supervisory deductions	(5,135)	(4,864)
Total regulatory capital	18,877	15,675

	31 December 2007 £bn	31 December 2007 £bn
Total risk-weighted assets equivalent	172.0	142.6
Risk asset ratios:		
Tier 1	8.1%	9.5%
Total capital	11.0%	11.0%

The principal movements are:

- a reduction of tier 1 capital resources primarily arising from a deduction of 50 per cent of the difference between expected loss and accounting impairment provisions partially offset by related notional tax relief.
- a reduction of tier 2 capital resources primarily arising from a deduction of 50 per cent of the difference between expected loss and accounting impairment provisions, together with the removal of collective impairment provisions which no longer qualify as tier 2 capital under the Basel II rules.
- a reduction in supervisory deduction reflecting derecognition for capital adequacy purposes of mortgage securitisation.
- a reduction in total risk-weighted assets, reflecting the application of the IRB approach to the majority of the Group's credit portfolios, offset, in part, by the introduction of a specific charge for operational risk.

The above comparison is set out using the risk asset ratio framework, which, as explained above, remains the international standard for measuring capital adequacy. The FSA's approach to such measurement under Basel II is now based primarily on monitoring the relationship of the Capital Resources Requirement (CRR – broadly equivalent to 8 per cent of risk-weighted assets and thus representing the capital required under Pillar 1 of Basel II) to available capital resources. Notwithstanding this new approach, the Group will continue to report ratios both internally and externally. The FSA is also setting Individual Capital Guidance (ICG) for each UK bank, calibrated by reference to its CRR. A key input to the FSA's ICG setting process (which addresses the requirements of Pillar 2 under Basel II) is each bank's Internal Capital Adequacy Assessment Process (ICAAP). The Group submitted its ICAAP document to the FSA in April 2007. The FSA has made it clear that each ICG remains a confidential matter between each bank and the FSA.

Future changes to regulatory capital rules

The regulatory capital regime is subject to ongoing review and development by the regulator. The Group continues to work with the regulator to assess the impact on the Group's regulatory capital requirements and resources.

Life assurance businesses

The principal subsidiary involved in the Group's life assurance operations is Scottish Widows plc ('Scottish Widows'), which holds the only large With Profit Fund managed by the Lloyds TSB Group. Throughout 2006 and up until the third quarter of 2007, the Group also owned Abbey Life Assurance Company Limited (which had been closed to new business since March 2000) but this business was sold at the end of September 2007.

Basis of determining regulatory capital of the life assurance businesses

Available capital resources

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the FSA. Different rules apply depending on the nature of the fund, as detailed below.

Statutory basis. Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. Liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

'Realistic' basis. The FSA requires each life assurance company which contains a with-profits fund in excess of £500 million, including Scottish Widows, to carry out a 'realistic' valuation of that fund. The word 'realistic' in this context reflects the terminology used for reporting to the FSA and is an assessment of the financial position of a with-profits fund calculated under a prescribed methodology.

The valuation of with-profits assets in a with-profits fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profits business written in a with-profits fund (a relatively small amount of business in the case of Scottish Widows), it includes the present value of the anticipated future release of the prudent margins for adverse deviation. The realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities is carried out using a stochastic simulation model which values liabilities on a basis consistent with tradable market option contracts (a 'market-consistent' basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given below in the section entitled 'Options and guarantees'.

Regulatory capital requirements

Each life assurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the FSA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows, the regulatory capital requirement is a combination of amounts held in respect of actuarial reserves, sums at risk and maintenance expenses (the Long-Term Insurance Capital Requirement) and amounts required to cover various stress tests. The regulatory capital requirement is deducted from the available capital resources to give 'statutory excess capital'.

For Scottish Widows, no amount is required to cover the impact of stress tests on the actuarial reserves. However, a further test is required in respect of the With Profit Fund, which compares the level of 'realistic excess capital' to the 'statutory excess capital' of the With Profit Fund. In circumstances where the 'realistic excess capital' position is less than 'statutory excess capital', the Company is required to hold additional capital to cover the shortfall, but only to the extent it exceeds the value, calculated in a prescribed way, of internal transfers from the With Profit Fund. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component. The 'realistic excess capital' is calculated as the difference between realistic assets and realistic liabilities of the With Profit Fund with a further deduction to cover various stress tests.

The determination of realistic liabilities of the With Profit Fund in respect of Scottish Widows includes the value of internal transfers expected to be made from the With Profit Fund to the Non-Participating Fund of Scottish Widows. These internal transfers include charges on policies where the associated costs are borne by the Non-Participating Fund. The With-Profits Insurance Capital Component is reduced by the value, calculated in the stress test scenario, of these internal transfers, but only to the extent that credit has not been taken for the value of these charges in deriving actuarial reserves for the Non-Participating Fund.

Capital statement

The following table provides more detail regarding the sources of capital in the life assurance business. The figures quoted are based on management's current expectations pending completion of the annual financial return to the FSA. The figures allow for an anticipated transfer of £300 million from the Long Term Fund to the Shareholder Fund as at 31 December 2007.

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2007					
Assets attributable to the shareholder held outside the long-term funds	–	–	–	946	946
Assets attributable to the shareholder held within the long-term funds	–	2,346	2,346	–	2,346
Total shareholders' funds	–	2,346	2,346	946	3,292
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	569	–	569	–	569
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities	–	(431)	(431)	(600)	(1,031)
Adjustment to include estimated 'realistic' liabilities payable to the shareholder	(634)	–	(634)	–	(634)
Adjustment to replace 'realistic' liabilities with statutory liabilities	3,696	–	3,696	–	3,696
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(23)	–	(23)	–	(23)
Qualifying loan capital	–	–	–	541	541
Available capital resources	3,608	1,915	5,523	887	6,410

The figures shown above for available capital resources within the insurance business relate to Scottish Widows plc only. The estimated total additional resources relating to the other life assurance subsidiaries within the Group are £330 million.

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The comparative position as at 31 December 2006 was as follows (again, relating to Scottish Widows plc only):

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2006					
Assets attributable to the shareholder held outside the long-term funds	–	–	–	1,947	1,947
Assets attributable to the shareholder held within the long-term funds	–	2,225	2,225	–	2,225
Total shareholders' funds	–	2,225	2,225	1,947	4,172
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	615	–	615	–	615
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities	–	(263)	(263)	(810)	(1,073)
Adjustment to include estimated 'realistic' liabilities payable to the shareholder	(680)	–	(680)	–	(680)
Adjustment to replace 'realistic' liabilities with statutory liabilities	3,783	–	3,783	–	3,783
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(32)	–	(32)	–	(32)
Qualifying loan capital	–	–	–	533	533
Available capital resources	3,686	1,962	5,648	1,670	7,318

Formal intra-group capital arrangements

Scottish Widows has a formal arrangement with one of its subsidiary undertakings, Scottish Widows Unit Funds Limited, whereby the subsidiary company can draw down capital from Scottish Widows to finance new business which is reinsured from the parent to its subsidiary. Scottish Widows has also provided subordinated loans to its subsidiary Scottish Widows Annuities Limited and its fellow group undertaking Scottish Widows Bank plc.

Constraints over available capital resources

Scottish Widows was created following the demutualisation of Scottish Widows Fund and Life Assurance Society in 2000. The terms of the demutualisation are governed by a Court-approved Scheme of Transfer (the 'Scheme') which, inter alia, created a With Profit Fund and a Non-Participating Fund and established protected capital support for the with-profits policyholders in existence at the date of demutualisation. Much of that capital support is held in the Non-Participating Fund and, as such, the capital held in that fund is subject to the constraints noted below.

Requirement to maintain a Support Account: The Scheme requires the maintenance of a 'Support Account' within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation and must be maintained until the value of these assets reaches a minimum level. Assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the FSA permission to include the value of the Support Account in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2007, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,915 million (31 December 2006: £1,962 million) and the estimated value of the Support Account was £827 million (31 December 2006: £974 million).

Further Support Account: The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2007, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £4,028 million (31 December 2006: £3,962 million) and the estimated combined value of the Support Account and Further Support Account was £2,834 million (31 December 2006: £2,873 million).

Other restrictions in the Non-Participating Fund: In addition to the policies which existed at the date of demutualisation, the With Profit Fund includes policies which have been written since that date. As a result of statements made to policyholders that investment policy will usually be the same for both types of business, there is an implicit requirement to hold additional regulatory assets in respect of the business written after demutualisation. The estimated amount required to provide such support at 31 December 2007 is £193 million (31 December 2006: £216 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year end and the new business expected to be written over the following year.

Movements in regulatory capital

The movements in Scottish Widows plc's available capital resources can be analysed as follows:

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2006	3,686	1,962	5,648	1,670	7,318
Changes in assumptions used to measure life assurance liabilities	(104)	(40)	(144)	–	(144)
Dividends and capital transfers	–	(300)	(300)	(1,560)	(1,860)
Changes in regulatory requirements	–	69	69	–	69
New business and other factors	26	224	250	777	1,027
As at 31 December 2007	**3,608**	**1,915**	**5,523**	**887**	**6,410**

The primary reasons for the movement in total available capital resources during the year are as follows:

With Profit Fund

Available capital in the With Profit Fund has decreased from £3,686 million at 31 December 2006 to an estimated £3,608 million at 31 December 2007. The key driver is investment market performance, which was broadly neutral over 2007.

Non-Participating Fund

Available capital in the Non-Participating Fund has decreased from £1,962 million at 31 December 2006 to an estimated £1,915 million at 31 December 2007. This is primarily a result of the anticipated transfer from the Non-Participating Fund to the Shareholder Fund at the year end of £300 million, offset by the return generated from the business.

Shareholder Fund

During 2007, dividends of £1,860 million were paid. These were partly financed by the sale of Abbey Life Assurance Company Limited.

Financial information calculated on a 'realistic' basis

The estimated financial position of the With Profit Fund of Scottish Widows at 31 December 2007, calculated on a 'realistic' basis, is given in the following table, in the form reported to the FSA. As a result of the capital support arrangements, it is considered appropriate to also disclose the estimated 'realistic' financial position of the Long Term Fund of Scottish Widows as a whole, which consists of both the With Profit Fund and the Non-Participating Fund.

	31 December 2007		31 December 2006	
	With Profit Fund £m	Long Term Fund £m	With Profit Fund £m	Long Term Fund £m
Realistic value of assets of fund	16,781	20,929	18,183	22,278
Support arrangement assets	1,020	–	1,190	–
Realistic value of assets available to the fund	17,801	20,929	19,373	22,278
Realistic value of liabilities of fund	(16,846)	(16,901)	(18,248)	(18,316)
Working capital for fund	955	4,028	1,125	3,962
Working capital ratio for fund	5.4%	19.2%	5.8%	17.9%

The financial information calculated on a 'realistic' basis reconciles to the Capital statement as follows:

	31 December 2007		31 December 2006	
	With Profit Fund £m	Long Term Fund £m	With Profit Fund £m	Long Term Fund £m
Available regulatory capital	3,608	5,523	3,686	5,648
Support arrangement assets	1,020	–	1,190	–
Adjustments to replace statutory liabilities with 'realistic' liabilities	(3,696)	(3,582)	(3,783)	(3,614)
Adjustments to include the value of future profits recognised in respect of Non-Participating business written in the With Profit Fund	23	23	32	32
Recognition of future profits allowable for 'realistic' capital purposes	–	2,064	–	1,896
	955	4,028	1,125	3,962

Analysis of policyholder liabilities in respect of the Group's life assurance business:

	Scottish Widows plc With Profit Fund (in accordance with FRS 27) £m	Other long-term funds £m	Total life business £m
As at 31 December 2007			
With Profit Fund liabilities	16,404	–	16,404
Unit-linked business (excluding that accounted for as investment contracts)	–	14,282	14,282
Other life assurance business	–	6,714	6,714
Insurance and participating investment contract liabilities	16,404	20,996	37,400
Non-participating investment contract liabilities	–	18,197	18,197
Total policyholder liabilities	16,404	39,193	55,597

	Scottish Widows plc With Profit Fund (in accordance with FRS 27) £m	Other long-term funds £m	Total life business £m
As at 31 December 2006			
With Profit Fund liabilities	17,827	116	17,943
Unit-linked business (excluding that accounted for as investment contracts)	–	12,734	12,734
Other life assurance business	–	10,181	10,181
Insurance and participating investment contract liabilities	17,827	23,031	40,858
Non-participating investment contract liabilities	–	24,370	24,370
Total policyholder liabilities	17,827	47,401	65,228

The sale of Abbey Life Assurance Company Limited during 2007 reduced total policyholder liabilities by £11,632 million.

Capital sensitivities

Shareholders' funds

Shareholders' funds outside the long-term business fund, other than those used to match regulatory requirements, are mainly invested in assets that are less sensitive to market conditions.

With Profit Fund

The with-profits realistic liabilities and the available capital for the With Profit Fund are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put options also increases the market consistent value of the options given to policyholders and worsens the capital position.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the With Profit Fund is partly mitigated by the actions that can be taken by management.

Other long-term funds

Outside the With Profit Fund, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of life assurance contracts. In addition, poor cost control would gradually depreciate the available capital and lead to an increase in the valuation of the liabilities (through an increased allowance for future costs).

Assets held in excess of those backing actuarial reserves are invested across a range of investment categories including fixed interest securities, equities, properties and cash. The mix of investments is determined in line with the policy of Lloyds TSB Group to minimise the working capital (defined as available capital less minimum required capital) required to ensure all capital requirements continue to be met under a range of stress tests.

Options and guarantees

The Group has sold insurance products that contain options and guarantees, both within the With Profit Fund and in other funds.

Options and guarantees within the With Profit Fund

The most significant options and guarantees provided from within the With Profit Fund are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies. For those policies written pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With Profit Fund of Scottish Widows called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2007 of £1.7 billion (2006: £1.8 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of the With Profit Fund are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are:

- Risk-free yield. The risk-free yield is defined as 0.1 per cent higher than spot yields derived from the UK gilt yield curve.
- Investment volatility. The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2007, the 10 year equity-implied at-the-money assumption was set at 25.5 per cent (31 December 2006: 20 per cent). The assumption for property volatility was 15 per cent (31 December 2006: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 11 per cent (31 December 2006: 13 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

Options and guarantees outside the With Profit Fund of Scottish Widows

Certain personal pension policyholders, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £65 million (31 December 2006: £98 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by some £3 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £12 million.

Five year financial summary

The financial information set out in the table below has been derived from the annual report and accounts of Lloyds TSB Group plc for each of the past five years. 2005 was the first year in which the annual report and accounts were prepared under International Financial Reporting Standards (IFRS). 2004 and earlier years had been prepared under UK Generally Accepted Accounting Principles (UK GAAP) and earlier years had been adjusted for subsequent changes in accounting policy and presentation. To bridge the change in framework, 2004 figures have been presented under both IFRS and UK GAAP. Under IFRS, accounting standards dealing with financial instruments (IAS 32 and IAS 39) and insurance (IFRS 4 and FRS 27) were applied only from 1 January 2005. To aid comparison, IFRS balance sheet data is presented as at 1 January 2005 rather than 31 December 2004; the 2004 IFRS income statement data is not comparable to the data for 2005 and 2006. The financial statements for each of the years presented have been audited by PricewaterhouseCoopers LLP, independent auditors.

	IFRS				UK GAAP	
	2007	2006	2005	2004	2004	2003
Income statement data for the year ended 31 December (£m)						
Total income, net of insurance claims	10,706	11,104	10,540	9,661	9,343	9,672
Operating expenses	(5,567)	(5,301)	(5,471)	(5,297)	(4,917)	(5,173)
Trading surplus	5,139	5,803	5,069	4,364	4,426	4,499
Impairment	(1,796)	(1,555)	(1,299)	(866)	(866)	(950)
Profit before tax	4,000	4,248	3,820	3,477	3,493	4,348
Profit for the year	3,321	2,907	2,555	2,459	2,489	3,323
Profit for the year attributable to equity shareholders	3,289	2,803	2,493	2,392	2,421	3,254
Total dividend for the year[1]	2,026	1,927	1,915	1,914	1,914	1,911
	31 December 2007	31 December 2006	31 December 2005	1 January 2005	31 December 2004	31 December 2003
Balance sheet data (£m)						
Share capital	1,432	1,429	1,420	1,419	1,419	1,418
Shareholders' equity	12,141	11,155	10,195	9,489	9,977	9,624
Net asset value per ordinary share	212p	195p	180p	167p	176p	170p
Customer accounts	156,555	139,342	131,070	126,349	122,062	116,496
Subordinated liabilities	11,958	12,072	12,402	11,211	10,252	10,454
Loans and advances to customers	209,814	188,285	174,944	161,162	154,240	135,251
Total assets	353,346	343,598	309,754	292,854	279,843	252,012
	2007	2006	2005	2004	2004	2003
Share information						
Basic earnings per ordinary share	58.3p	49.9p	44.6p	42.8p	43.3p	58.3p
Diluted earnings per ordinary share	57.9p	49.5p	44.2p	42.5p	43.0p	58.1p
Total dividend per ordinary share[1]	35.9p	34.2p	34.2p	34.2p	34.2p	34.2p
Market price (year end)	472.0p	571.5p	488.5p	473p	473p	448p
Number of shareholders (thousands)	814	870	920	953	953	974
Number of ordinary shares in issue (millions)[2]	5,648	5,638	5,603	5,596	5,596	5,594
	2007	2006	2005	2004	2004	2003
Financial ratios (%)[3]						
Dividend payout ratio	61.6	68.7	76.8	80.0	79.1	58.7
Post-tax return on average shareholders' equity	28.2	26.6	25.6	22.8	24.3	38.5
Post-tax return on average risk-weighted assets	2.03	1.89	1.81	1.99	2.01	2.63
Cost:income ratio[4]	52.0	47.7	51.9	54.8	51.4	52.2
	31 December 2007	31 December 2006	31 December 2005	1 January 2005	31 December 2004	31 December 2003
Capital ratios (%)						
Total capital	11.0	10.7	10.9	10.1	10.0	11.3
Tier 1 capital	8.1	8.2	7.9	8.2	8.9	9.5

[1] Annual dividends comprise both interim and estimated final dividend payments. Under IFRS, the total dividend for the year represents the interim dividend paid during the year and the final dividend which will be paid and accounted for during the following year. Under UK GAAP, final dividends are included in the year to which they relate rather than in the year in which they are paid.

[2] This figure excludes 79 million limited voting ordinary shares.

[3] Averages are calculated on a monthly basis from the consolidated financial data of Lloyds TSB Group.

[4] The cost:income ratio is calculated as total operating expenses as a percentage of total income (net of insurance claims for the IFRS numbers in 2004 and later years).