

Report of the independent auditors on the consolidated financial statements

To the members of Lloyds TSB Group plc

We have audited the consolidated financial statements of Lloyds TSB Group plc for the year ended 31 December 2007 which comprise the consolidated income statement, the consolidated balance sheet, the consolidated statement of changes in equity, the consolidated cash flow statement and the related notes. These consolidated financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent company financial statements of Lloyds TSB Group plc for the year ended 31 December 2007 and on the information in the directors' remuneration report that is described as having been audited.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report and the consolidated financial statements in accordance with applicable law and International Financial Reporting Standards ('IFRSs') as adopted by the European Union are set out in the statement of directors' responsibilities on page 63.

Our responsibility is to audit the consolidated financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the consolidated financial statements give a true and fair view and whether the consolidated financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you whether, in our opinion, the information given in the directors' report is consistent with the consolidated financial statements. The information given in the directors' report includes that specific information presented in the Overview and the Business Review that is cross referred from the principal activities, business review, future developments and financial risk management objectives and policies section of the directors' report.

In addition we report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the corporate governance statement reflects the Company's compliance with the nine provisions of the Combined Code (2006) specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the annual report and consider whether it is consistent with the audited consolidated financial statements. The other information comprises only the Overview, the unaudited part of the Business Review, the directors' report, the corporate governance disclosures, the unaudited part of the directors' remuneration report and the shareholder information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the consolidated financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the consolidated financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the consolidated financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the consolidated financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the consolidated financial statements.

Opinion

In our opinion:

- the consolidated financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2007 and of its profit and cash flows for the year then ended;
- the consolidated financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the directors' report is consistent with the consolidated financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Southampton, England
21 February 2008

Consolidated income statement

for the year ended 31 December 2007

| | Note | 2007 £ million | 2006 £ million |
|----------------------------------------------|------|-------------------|-------------------|
| Interest and similar income | | 16,874 | 14,108 |
| Interest and similar expense | | (10,775) | (8,779) |
| Net interest income | 4 | 6,099 | 5,329 |
| Fee and commission income | | 3,224 | 3,116 |
| Fee and commission expense | | (600) | (638) |
| Net fee and commission income | 5 | 2,624 | 2,478 |
| Net trading income | 6 | 3,123 | 6,341 |
| Insurance premium income | 7 | 5,430 | 4,719 |
| Other operating income | 8 | 952 | 806 |
| Other income | | 12,129 | 14,344 |
| Total income | | 18,228 | 19,673 |
| Insurance claims | 9 | (7,522) | (8,569) |
| Total income, net of insurance claims | | 10,706 | 11,104 |
| Operating expenses | 10 | (5,567) | (5,301) |
| Trading surplus | | 5,139 | 5,803 |
| Impairment | 11 | (1,796) | (1,555) |
| Profit on sale of businesses | 12 | 657 | – |
| Profit before tax | | 4,000 | 4,248 |
| Taxation | 13 | (679) | (1,341) |
| Profit for the year | | 3,321 | 2,907 |
| Profit attributable to minority interests | | 32 | 104 |
| Profit attributable to equity shareholders | | 3,289 | 2,803 |
| Profit for the year | | 3,321 | 2,907 |
| Basic earnings per share | 14 | 58.3p | 49.9p |
| Diluted earnings per share | 14 | 57.9p | 49.5p |

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated balance sheet

at 31 December 2007

| | Note | 2007 £ million | 2006 £ million |
|-------------------------------------------------------------------------|------|-------------------|-------------------|
| Assets | | | |
| Cash and balances at central banks | | 4,330 | 1,898 |
| Items in the course of collection from banks | | 1,242 | 1,431 |
| Trading and other financial assets at fair value through profit or loss | 15 | 57,911 | 67,695 |
| Derivative financial instruments | 16 | 8,659 | 5,565 |
| Loans and advances to banks | 17 | 34,845 | 40,638 |
| Loans and advances to customers | 18 | 209,814 | 188,285 |
| Available-for-sale financial assets | 20 | 20,196 | 19,178 |
| Investment property | 21 | 3,722 | 4,739 |
| Goodwill | 22 | 2,358 | 2,377 |
| Value of in-force business | 23 | 2,218 | 2,723 |
| Other intangible assets | 24 | 149 | 138 |
| Tangible fixed assets | 25 | 2,839 | 4,252 |
| Other assets | 26 | 5,063 | 4,679 |
| Total assets | | 353,346 | 343,598 |

The accompanying notes are an integral part of the consolidated financial statements.

The directors approved the consolidated financial statements on 21 February 2008.

Sir Victor Blank
Chairman

J Eric Daniels
Group Chief Executive

Helen A Weir
Group Finance Director

Consolidated balance sheet

at 31 December 2007

| Equity and liabilities | Note | 2007 £ million | 2006 £ million |
|-------------------------------------------------------------------------------------|------|-------------------|-------------------|
| Liabilities | | | |
| Deposits from banks | 27 | 39,091 | 36,394 |
| Customer accounts | 28 | 156,555 | 139,342 |
| Items in course of transmission to banks | | 668 | 781 |
| Trading and other liabilities at fair value through profit or loss | 29 | 3,206 | 1,184 |
| Derivative financial instruments | 16 | 7,582 | 5,763 |
| Debt securities in issue | 30 | 51,572 | 54,118 |
| Liabilities arising from insurance contracts and participating investment contracts | 31 | 38,063 | 41,445 |
| Liabilities arising from non-participating investment contracts | 32 | 18,197 | 24,370 |
| Unallocated surplus within insurance businesses | 33 | 554 | 683 |
| Other liabilities | 34 | 9,690 | 10,985 |
| Retirement benefit obligations | 35 | 2,144 | 2,462 |
| Current tax liabilities | | 484 | 817 |
| Deferred tax liabilities | 36 | 948 | 1,416 |
| Other provisions | 37 | 209 | 259 |
| Subordinated liabilities | 38 | 11,958 | 12,072 |
| Total liabilities | | 340,921 | 332,091 |
| Equity | | | |
| Share capital | 39 | 1,432 | 1,429 |
| Share premium account | 40 | 1,298 | 1,266 |
| Other reserves | 41 | (60) | 336 |
| Retained profits | 42 | 9,471 | 8,124 |
| Shareholders' equity | | 12,141 | 11,155 |
| Minority interests | | 284 | 352 |
| Total equity | | 12,425 | 11,507 |
| Total equity and liabilities | | 353,346 | 343,598 |

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated statement of changes in equity

| | Attributable to equity shareholders | | | | Minority interests £ million | Total £ million |
|--------------------------------------------------------------|----------------------------------------|-----------------------------|-------------------------------|--------------------|---------------------------------|--------------------|
| | Share capital and premium £ million | Other reserves £ million | Retained profits £ million | Total £ million | | |
| Balance at 1 January 2006 | 2,590 | 395 | 7,210 | 10,195 | 435 | 10,630 |
| Movement in available-for-sale financial assets, net of tax: | | | | | | |
| – change in fair value | – | (10) | – | (10) | – | (10) |
| – transferred to income statement in respect of disposals | – | (21) | – | (21) | – | (21) |
| Movement in cash flow hedges, net of tax | – | 1 | – | 1 | – | 1 |
| Currency translation differences | – | (29) | – | (29) | (4) | (33) |
| Net income recognised directly in equity | – | (59) | – | (59) | (4) | (63) |
| Profit for the year | – | – | 2,803 | 2,803 | 104 | 2,907 |
| Total recognised income for 2006 | – | (59) | 2,803 | 2,744 | 100 | 2,844 |
| Dividends | – | – | (1,919) | (1,919) | (32) | (1,951) |
| Purchase/sale of treasury shares | – | – | (35) | (35) | – | (35) |
| Employee share option schemes: | | | | | | |
| – value of employee services | – | – | 65 | 65 | – | 65 |
| – proceeds from shares issued | 105 | – | – | 105 | – | 105 |
| Repayment of capital to minority shareholders | – | – | – | – | (151) | (151) |
| Balance at 31 December 2006 | 2,695 | 336 | 8,124 | 11,155 | 352 | 11,507 |
| Movement in available-for-sale financial assets, net of tax: | | | | | | |
| – change in fair value | – | (436) | – | (436) | – | (436) |
| – transferred to income statement in respect of disposals | – | (5) | – | (5) | – | (5) |
| – transferred to income statement in respect of impairment | – | 49 | – | 49 | – | 49 |
| – disposal of businesses | – | (6) | – | (6) | – | (6) |
| Movement in cash flow hedges, net of tax | – | (15) | – | (15) | – | (15) |
| Currency translation differences | – | 17 | – | 17 | (1) | 16 |
| Net income recognised directly in equity | – | (396) | – | (396) | (1) | (397) |
| Profit for the year | – | – | 3,289 | 3,289 | 32 | 3,321 |
| Total recognised income for 2007 | – | (396) | 3,289 | 2,893 | 31 | 2,924 |
| Dividends | – | – | (1,957) | (1,957) | (19) | (1,976) |
| Purchase/sale of treasury shares | – | – | (1) | (1) | – | (1) |
| Employee share option schemes: | | | | | | |
| – value of employee services | – | – | 16 | 16 | – | 16 |
| – proceeds from shares issued | 35 | – | – | 35 | – | 35 |
| Repayment of capital to minority shareholders | – | – | – | – | (80) | (80) |
| Balance at 31 December 2007 | 2,730 | (60) | 9,471 | 12,141 | 284 | 12,425 |

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated cash flow statement

for the year ended 31 December 2007

| | Note | 2007 £ million | 2006 £ million |
|------------------------------------------------------------------------|-------|-------------------|-------------------|
| Profit before tax | | 4,000 | 4,248 |
| Adjustments for: | | | |
| Change in operating assets | 49(a) | (16,982) | (31,995) |
| Change in operating liabilities | 49(b) | 21,541 | 33,069 |
| Non-cash and other items | 49(c) | 2,784 | 1,555 |
| Tax paid | | (859) | (798) |
| Net cash provided by operating activities | | 10,484 | 6,079 |
| Cash flows from investing activities | | | |
| Purchase of available-for-sale financial assets | | (21,667) | (23,448) |
| Proceeds from sale and maturity of available-for-sale financial assets | | 19,468 | 18,106 |
| Purchase of fixed assets | | (1,334) | (1,724) |
| Proceeds from sale of fixed assets | | 982 | 1,257 |
| Acquisition of businesses, net of cash acquired | 49(f) | (8) | (20) |
| Disposal of businesses, net of cash disposed | 49(g) | 1,476 | 936 |
| Net cash used in investing activities | | (1,083) | (4,893) |
| Cash flows from financing activities | | | |
| Dividends paid to equity shareholders | | (1,957) | (1,919) |
| Dividends paid to minority interests | 49(e) | (19) | (32) |
| Interest paid on subordinated liabilities | | (709) | (713) |
| Proceeds from issue of subordinated liabilities | 49(e) | – | 1,116 |
| Proceeds from issue of ordinary shares | 49(e) | 35 | 105 |
| Repayment of subordinated liabilities | 49(e) | (300) | (759) |
| Repayment of capital to minority shareholders | 49(e) | (80) | (151) |
| Net cash used in financing activities | | (3,030) | (2,353) |
| Effects of exchange rate changes on cash and cash equivalents | | 82 | (148) |
| Change in cash and cash equivalents | | 6,453 | (1,315) |
| Cash and cash equivalents at beginning of year | | 25,438 | 26,753 |
| Cash and cash equivalents at end of year | 49(d) | 31,891 | 25,438 |

The accompanying notes are an integral part of the consolidated financial statements.

Notes to the group accounts

1 Accounting policies

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 'Financial Instruments: Recognition and Measurement' relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The following IFRS pronouncements relevant to the Group have been adopted in these consolidated financial statements:

- (i) IFRS 7 'Financial Instruments: Disclosures'. This standard, which was effective from 1 January 2007, requires more detailed qualitative and quantitative disclosures about exposure to risks arising from the Group's financial instruments. As a disclosure standard, the application of this new standard has not had any impact on amounts recognised in the financial statements. The IFRS 7 disclosures are set out in these financial statements and in the business review on pages 36 to 51. IFRS 7 supersedes IAS 30 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions' and the disclosure requirements previously contained in IAS 32 'Financial Instruments: Presentation'.
- (ii) Amendment to IAS 1 'Presentation of Financial Statements – Capital Disclosures'. This standard, which was effective from 1 January 2007, requires additional disclosures of the objectives, policies and processes for managing capital, quantitative data about what the Group regards as capital, and compliance with capital requirements. These disclosures are set out in the business review on pages 48 to 56.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2007 and which have not been applied in preparing these financial statements are given in note 50.

The Group's accounting policies are set out below.

(a) Consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include all entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Group undertakings are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Open Ended Investment Companies (OEICs) where the Group, through the Group's life funds, has a controlling interest are consolidated; the unit holders' interest is reported in other liabilities. Intra-Group transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

(b) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable net assets and contingent liabilities of the acquired entity at the date of acquisition. Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a Group undertaking, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

(c) Other intangible assets

Other intangible assets comprise capitalised software enhancements and customer lists. Capitalised software enhancements are amortised over periods not exceeding five years, being their estimated useful lives, using the straight-line method. Customer lists are amortised over periods not exceeding 15 years, being their estimated useful lives, in line with the income expected to arise from those customers and are subject to annual reassessment. All other intangible assets are reviewed for impairment whenever events or any changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount, it is written down immediately.

(d) Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by the Group including expected early redemptions and related penalties and premiums and discounts that are an integral part of the overall return as well as direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see j).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to life assurance and general insurance business are detailed below (see r).

1 Accounting policies continued

(e) Trading securities, other financial assets and liabilities at fair value through profit or loss, and available-for-sale financial assets

Debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

Financial assets and liabilities are designated as at fair value through profit or loss on acquisition:

- When doing so results in more relevant information because either:
 - it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on them on a different basis; or
 - the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy with management information also prepared on this basis, or
- Where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

Debt securities and equity shares, other than those classified as trading securities or at fair value through profit or loss, are classified as available-for-sale and recognised in the balance sheet at their fair value; available-for-sale investments are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in equity, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in equity is recognised in the income statement. Interest calculated using the effective interest method is recognised in the income statement.

Purchases and sales of securities and other financial assets and liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset. Trading securities and other financial assets and liabilities at fair value through profit or loss are initially recognised at fair value. Available-for-sale financial assets are initially recognised at fair value inclusive of transaction costs. These financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

(f) Loans and advances to banks and customers

Loans and advances to banks and customers are accounted for at amortised cost using the effective interest method, except those which the Group intends to sell in the near term and which are accounted for at fair value, with the gains and losses arising from changes in their fair value reflected in the income statement. Loans and advances are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs. Loans and advances are derecognised when the rights to receive cash flows from them have expired or where the Group has transferred substantially all risks and rewards of ownership.

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. Such financial assets continue to be recognised by the Group, together with a corresponding liability for the funding except in those cases where substantially all of the risks and rewards associated with the assets have been transferred or a significant proportion but not all of the risks and rewards have been transferred and the transferee has the ability to sell the assets when the assets are derecognised in full. If a fully proportional share of all, or of specifically identified, cash flows have been transferred, then that proportion of the assets is derecognised.

(g) Sale and repurchase agreements

Securities sold subject to repurchase agreements ('repos') are recognised on the balance sheet where all of the risks and rewards are retained; the counterparty liability is included in deposits from banks or customer accounts, as appropriate. Securities purchased under agreements to resell ('reverse repos') are recorded as loans and advances to banks or customers, as appropriate. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.

(h) Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative.

The method of recognising the movements in the fair value of the derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Derivatives may only be designated as hedges provided certain strict criteria are met. At the inception of a hedge its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship must be tested throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its objective the hedge relationship is terminated.

The Group designates certain derivatives as either: (1) hedges of the fair value of the interest rate risk inherent in recognised assets or liabilities (fair value hedges); (2) hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges); or (3) hedges of net investments in foreign operations (net investment hedges). These are accounted for as follows:

1 Accounting policies continued

(1) Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value attributable to the hedged risk are no longer recognised in the income statement; the adjustment that has been made to the carrying amount of a hedged item is amortised to the income statement over the period to maturity.

(2) Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

(3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of.

Changes in the fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement.

Derivatives embedded in financial instruments and insurance contracts (unless the embedded derivative is itself an insurance contract) are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. In accordance with IFRS 4 a policyholder's option to surrender an insurance contract for a fixed amount is not treated as an embedded derivative.

(i) Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(j) Impairment of financial assets

(1) Assets accounted for at amortised cost

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition, there is objective evidence that a financial asset or group of financial assets has become impaired.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss may include:

- Delinquency in contractual payments of principal and/or interest;
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty;
- Restructuring of debt to reduce the burden on the borrower;
- Breach of loan covenants or conditions; and
- Initiation of bankruptcy proceedings.

The estimated period between a loss occurring and its identification is determined by local management for each identified portfolio. In general, the periods used vary between three months and nine months.

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate. For the Group's portfolios of smaller balance homogenous loans, such as the residential mortgage, personal lending and credit card portfolios, allowances are calculated for groups of assets taking into account historical cash flow experience. For the Group's other lending portfolios, allowances are established on a case-by-case basis. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised asset or group of assets reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

If there is no objective evidence of individual impairment the asset is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment. Segmentation takes into account such factors as the type of asset, industry, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

1 Accounting policies continued

(2) Available-for-sale financial assets

The Group assesses at each balance sheet date whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost, reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer and assessing the future cash flows expected to be realised. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(3) Renegotiated loans

Loans that are either subject to collective impairment assessment or individually significant and whose terms have been renegotiated are no longer considered to be past due but are treated as new loans. In subsequent years, the asset is considered to be past due and disclosed only if further renegotiated.

(k) Investment property

Property held for long-term rental yields and capital appreciation within the long-term assurance funds is classified as investment property. Investment property comprises freehold and long leasehold land and buildings and is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices on less active markets. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recorded in the income statement.

(l) Tangible fixed assets

Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease
- Leasehold improvements: shorter of 10 years or the remaining period of the lease

Equipment:

- Fixtures and furnishings: 10-20 years
- Other equipment and motor vehicles: 2-8 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(m) Leases

(1) As lessee

The leases entered into by the Group are primarily operating leases. Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

(2) As lessor

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee; all other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments is recognised as a receivable within loans and advances to banks and customers. Finance lease income is recognised over the term of the lease using the net investment method (before tax) reflecting a constant periodic rate of return.

Operating lease assets are included within tangible fixed assets at cost and depreciated over the life of the lease after taking into account anticipated residual values. Operating lease rental income is recognised on a straight line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

(n) Borrowings

Borrowings (which include deposits from banks, customer accounts, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

Notes to the group accounts

1 Accounting policies continued

(o) Pensions and other post-retirement benefits

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries, or in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

The Group's income statement includes the current service cost of providing pension benefits, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities ('the corridor approach'). In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives. Past service costs are charged immediately to the income statement, unless the charges are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

The Group's balance sheet includes the net surplus or deficit, being the fair value of scheme assets less the discounted value of scheme liabilities adjusted for the corridor. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

The Group recognises the effect of material changes to the terms of its defined benefit pension plans which reduce future benefits as curtailments; gains and losses are recognised in the income statement when the curtailments occur.

The costs of the Group's defined contribution plans are charged to the income statement in the period in which they fall due.

(p) Share-based compensation

The Group operates a number of equity-settled, share-based compensation plans. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement over the remaining vesting period, together with a corresponding adjustment to equity.

(q) Taxation

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

For the Group's long-term assurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on equity holders' returns. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred tax is provided on temporary differences arising from investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred tax related to fair value re-measurement of available-for-sale investments and cash flow hedges, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement together with the deferred gain or loss.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

(r) Insurance

The Group undertakes both life assurance and general insurance business.

For accounting purposes the life assurance business issues three types of contract:

Insurance contracts – these contracts contain significant insurance risk, which the Group defines as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur.

Investment contracts containing a discretionary participation feature – these contracts do not contain significant insurance risk, but contain features which entitle the holder to receive, in addition to the guaranteed benefits, further amounts that are likely to be a significant proportion of the total benefits and the amount and timing of which is at the discretion of the Group and based upon the performance of specified assets. Contracts with a discretionary participation feature are referred to as participating investment contracts.

Non-participating investment contracts – these contracts do not contain significant insurance risk or a discretionary participation feature.

For accounting purposes the general insurance business only issues insurance contracts.

1 Accounting policies continued

(1) Life assurance business

(i) Accounting for insurance and participating investment contracts

- **Premiums and claims**

Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due, except as detailed below in respect of unit-linked contracts.

Claims are recorded as an expense when they are incurred.

- **Liabilities**

- **insurance or participating investment contracts in the Group's With Profit Fund**

Liabilities of the Group's With Profit Fund, including guarantees and options embedded within products written by that fund, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime. Further details on the realistic capital regime are given on page 54.

- **insurance or participating investment contracts which are not unit-linked or in the Group's With Profit Fund**

A liability for contractual benefits that are expected to be incurred in the future is recorded when the premiums are recognised. The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life assurance and annuity benefits where future mortality is uncertain.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs.

- **insurance or participating investment contracts which are unit-linked**

Allocated premiums in respect of unit-linked contracts that are either insurance or participating investment contracts are recognised as liabilities. These liabilities are increased or reduced by the change in the unit prices and are reduced by policy administration fees, mortality and surrender charges and any withdrawals. The mortality charges deducted in each period from the policyholders as a group are considered adequate to cover the expected total death benefit claims in excess of the contract account balances in each period and hence no additional liability is established for these claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges. Interest or changes in the unit prices credited to the account balances and excess benefit claims in excess of the account balances incurred in the period are charged as expenses in the income statement.

- **Unallocated surplus**

Any amounts in the With Profit Fund not yet determined as being due to policyholders are recognised as an unallocated surplus which is shown separately from other liabilities.

- **Value of in-force business**

The Group recognises as an asset the value of in-force business in respect of life insurance and participating investment contracts. The asset represents the present value of the shareholders' interest in the profits expected to emerge from those contracts written at the balance sheet date. This is determined using appropriate allowance for economic conditions and appropriate assumptions for future mortality rates and future persistency rates, making allowance for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets, including an explicit allowance for non-market risk. The asset in the consolidated balance sheet is presented gross of attributable tax and movements in the asset are reflected within other operating income in the income statement.

(ii) Accounting for non-participating investment contracts

All of the Group's non-participating investment contracts are unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitheld investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable.

Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability.

The Group receives investment management fees in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the instrument. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them on a straight-line basis over the estimated lives of the contracts.

Directly incremental commissions that vary with and are related to either securing new or renewing existing non-participating investment contracts are deferred; all other costs are recognised as expenses when incurred. This asset is subsequently amortised over the period of the provision of investment management services and is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately.

(2) General insurance business

The Group both underwrites and acts as intermediary in the sale of general insurance products. Underwriting premiums are included, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

The underwriting business makes provision for the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date. Claims liabilities are not discounted.

(3) Liability adequacy test

At each balance sheet date liability adequacy tests are performed to ensure the adequacy of insurance and participating investment contract liabilities net of related deferred tax assets and acquired value of in-force business. In performing these tests current best estimates of discounted future contractual cash flows and claims handling and administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to profit or loss by establishing a provision for losses arising from liability adequacy tests.

1 Accounting policies continued

(4) Reinsurance

Contracts entered into by the Group with reinsurers under which the Group is compensated for losses on one or more contracts issued by the Group and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held. Insurance contracts entered into by the Group under which the contract holder is another insurer (inwards reinsurance) are included with insurance contracts.

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised as an expense when due.

(s) Foreign currency translation

(1) Functional and presentation currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation currency.

(2) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items measured at fair value are recognised in profit or loss, except for differences on available-for-sale non-monetary financial assets such as equity shares, which are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

(3) Group companies

The results and financial position of all the Group entities (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- (i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- (ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- (iii) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities are taken to shareholders' equity. When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

(t) Provisions

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

(u) Dividends

Dividends on ordinary shares are recognised in equity in the period in which they are paid.

(v) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

2 Critical accounting estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to the Group's results and financial position, based upon materiality and significant judgements and estimates, are discussed below.

Impairment of financial assets

Loan impairment allowances

The Group regularly reviews its loan portfolios to assess for impairment. Impairment allowances are established to recognise incurred impairment losses in its loan portfolios carried at amortised cost. In determining whether an impairment has occurred at the balance sheet date the Group considers whether there is any observable data indicating that there has been a measurable decrease in the estimated future cash flows or their timings; such observable data includes whether there has been an adverse change in the payment status of borrowers or changes in economic conditions that correlate with defaults on loan repayment obligations. Where this is the case, the impairment loss is the difference between the carrying value of the loan and the present value of the estimated future cash flows discounted at the loan's original effective interest rate.

At 31 December 2007 gross loans and advances to customers and banks totalled £247,067 million (2006: £231,117 million) against which impairment allowances of £2,408 million (2006: £2,194 million) had been made.

There are two components of the Group's loan impairment allowances: individual and collective. All impaired loans which exceed a certain threshold, principally within the Group's corporate banking business, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security. The determination of these allowances often requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer and the value of the security held, for which there may not be a readily accessible market. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Impairment allowances for portfolios of smaller balance homogenous loans, such as residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis. Collective impairment allowances are calculated on a portfolio basis using formulae which take into account factors such as the length of time that the customer's account has been out of order, historical loss rates, the credit quality of the portfolios and the value of any security held. The variables used in the formulae are kept under regular review to ensure that as far as possible they reflect current economic circumstances; however changes in interest rates, unemployment levels and bankruptcy trends, particularly in the UK, could result in actual losses differing from reported impairment allowances.

Impairment of available-for-sale financial assets

In determining whether an impairment loss has been incurred in respect of an available-for-sale financial asset, the Group performs an objective review of the current financial circumstances and future prospects of the issuer and considers whether there has been a significant or prolonged decline in the fair value of that asset below its cost. This consideration requires management judgement. Among factors considered by the Group is whether the decline in fair value is a result of a change in the quality of the asset or a downward movement in the market as a whole. An assessment is performed of the expected future cash flows expected to be realised from the asset, taking into account, where appropriate, the quality of underlying security and credit protection available. The movement in available-for-sale financial assets is shown in note 20. The reduction in the fair value of available-for-sale financial assets during the year was £483 million (2006: £10 million). Impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement totalled £70 million (2006: £nil).

Pensions

The net liability recognised in the balance sheet at 31 December 2007 in respect of the Group's retirement benefit obligations was £2,144 million (2006: £2,462 million) of which £2,033 million (2006: £2,362 million) related to defined benefit pension schemes. This liability excludes actuarial gains of £1,350 million (2006: £263 million) which the Group is permitted to leave unrecognised. The defined benefit pension schemes' gross deficit totalled £683 million (2006: £2,099 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The schemes' liabilities are calculated using the projected unit credit method, which takes into account projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. The resulting estimated cash flows are discounted at a rate equivalent to the market yield at the balance sheet date on high quality bonds with a similar duration and currency to the schemes' liabilities. In order to estimate the future cash flows, a number of financial and non-financial assumptions are made by management, changes to which could have a material impact upon the overall deficit or the net cost recognised in the income statement.

Two important assumptions are the rate of inflation and the expected lifetime of the schemes' members. The assumed rate of inflation affects the rate at which salaries are projected to grow and therefore the size of the pension that employees receive upon retirement and also the rate at which pensions in payment increase. Over the longer term rates of inflation can vary significantly; at 31 December 2007 it was assumed that the rate of inflation would be 3.3 per cent per annum (2006: 2.9 per cent), although if this was increased by 0.2 per cent the overall deficit would increase by approximately £550 million and the annual cost by approximately £20 million. A reduction of 0.2 per cent would reduce the overall deficit by approximately £500 million and the annual cost by approximately £40 million.

The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. An increase of one year in the expected lifetime of scheme members would increase the overall deficit by approximately £400 million and the annual cost by approximately £30 million; a reduction of one year would reduce the overall deficit by approximately £400 million and the annual cost by approximately £40 million.

The size of the overall deficit is also sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variations. At 31 December 2007 the discount rate used was 5.8 per cent (2006: 5.1 per cent); a reduction of 0.2 per cent would increase the overall deficit by approximately £550 million and the annual cost by approximately £15 million, while an increase of 0.2 per cent would reduce the net deficit by approximately £550 million and the annual cost by approximately £40 million.

2 Critical accounting estimates and judgements continued

Goodwill

At 31 December 2007 the Group carried goodwill on its balance sheet totalling £2,358 million (2006: £2,377 million), substantially all of which relates to acquisitions made a number of years ago.

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. The impairment review is performed by projecting future cash flows, excluding finance and tax, based upon budgets and plans and making appropriate assumptions about rates of growth and discounting these using a rate that takes into account prevailing market interest rates and the risks inherent in the business. If the present value of the projected cash flows is less than the carrying value of the underlying net assets and related goodwill an impairment charge is required in the income statement. This calculation requires the exercise of significant judgement by management; if the estimates made prove to be incorrect or performance does not meet expectations which affects the amount and timing of future cash flows, goodwill may become impaired in future periods.

Insurance

Life assurance business

The Group carries in its balance sheet an asset representing the value of in-force business in respect of life insurance and participating investment contracts of £2,218 million at 31 December 2007 (2006: £2,723 million). This asset, which is presented gross of attributable tax, represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. This is determined using appropriate allowance for economic conditions and appropriate assumptions for future mortality rates and future persistency rates, making allowance for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets, including an explicit allowance for non-market risk. These factors are inherently uncertain. If actual experience differs from that assumed this could significantly affect the value attributed. The process for determining key assumptions that have been made at 31 December 2007 is detailed in note 23.

At 31 December 2007 the Group also carried substantial liabilities to holders of life insurance policies in its balance sheet. The methodology used to value the liabilities is described in note 1 (r) (1). Liabilities arising from insurance contracts and participating investment contracts were £22,526 million and £14,874 million respectively (2006: £25,763 million and £15,095 million) and those arising from non-participating investment contracts totalled £18,197 million (2006: £24,370 million). Elements of the liabilities require assumptions about future investment returns, future mortality rates and future policyholder behaviour. The process for determining the key assumptions that have been made at 31 December 2007 and the impact on profit before tax of changes in key assumptions is detailed in note 31.

General insurance business

At 31 December 2007 the Group held a provision of £207 million (2006: £149 million) in respect of the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date.

While management believes that the liability carried at year end is adequate, the application of statistical techniques requires significant judgement. An increase of 10 per cent in the cost of claims would result in the recognition of an additional loss of approximately £20 million. Similarly, an increase of 10 per cent in the ultimate number of such claims would lead to an additional loss of approximately £20 million; some relief would arise from reinsurance contracts held.

Taxation

Significant judgement is required in determining the Group's income tax liabilities. In arriving at the current tax liability of £484 million and deferred tax liability of £948 million at 31 December 2007 (2006: current tax liability of £817 million and deferred tax liability of £1,416 million), the Group has taken account of tax issues that are subject to ongoing discussions with HM Revenue & Customs and other tax authorities. Calculations of these liabilities have been based on management's assessment of legal and professional advice, case law and other relevant guidance. In these situations, the various risks are categorised and approximate weightings applied in arriving at the assessment of the expected liability. Where the expected tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the current and deferred tax amounts in the period in which such determination is made.

Valuation of financial instruments

Trading securities, other financial assets and liabilities at fair value through profit or loss, derivatives and available-for-sale financial assets are stated at fair value. The fair value of these financial instruments is the amount for which an asset could be exchanged or a liability settled between willing parties in arm's length transactions. The fair values of financial instruments are determined by reference to observable market prices where these are available and the market is active. Where market prices are not available or are unreliable because of poor liquidity, fair values are determined using valuation techniques including cash flow models which, to the extent possible, use observable market parameters. The process of calculating the fair value using valuation techniques may necessitate the estimation of certain pricing parameters, assumptions or model characteristics. Changes in assumptions about these factors could affect reported fair values of financial instruments. The fair value movement on assets and liabilities held at fair value through profit or loss and gains in respect of instruments held for trading are disclosed in note 6. Movements in respect of available-for-sale financial assets, including those arising from changes in their fair value, are disclosed in note 20. The fair values of the Group's financial assets and liabilities are disclosed within note 47 on pages 141 and 142 together with an indication of the valuation technique used for each major asset or liability category.

3 Segmental analysis

Lloyds TSB Group is a leading financial services group, whose businesses provide a wide range of banking and financial services predominantly in the UK.

The Group's activities are organised into three segments: UK Retail Banking, Insurance and Investments and Wholesale and International Banking. Services provided by UK Retail Banking encompass the provision of banking and other financial services to personal customers, private banking and mortgages. Insurance and Investments offers life assurance, pensions and savings products, general insurance and asset management services. Wholesale and International Banking provides banking and related services for major UK and multinational companies, banks and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers, manages the Group's activities in financial markets through its treasury function and provides banking and financial services in some overseas locations.

Under the Group's transfer pricing arrangements, inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged. Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

For those derivative contracts entered into by business units for risk management purposes, the business unit retains the amount that would have been recognised on an accrual accounting basis (an amount equal to the interest element of the next payment on the swap) and transfers the remainder of the fair value of the swap to the central group segment where the resulting accounting volatility is managed through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the swap and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results, records volatility where it is managed and provides a fair presentation of the segments' operating performance. It is the basis on which the segments are managed and measured internally and is the basis of the Group's internal segmental reporting to the board.

| | UK Retail Banking £m | General insurance £m | Life, pensions and asset management £m | Insurance and Investments £m | Wholesale and International Banking £m | Central group items £m | Inter-segment eliminations £m | Total £m |
|--------------------------------------------------|----------------------------|----------------------------|-------------------------------------------------|---------------------------------------|----------------------------------------------------|------------------------------|-------------------------------------|-------------|
| Year ended 31 December 2007 | | | | | | | | |
| Interest and similar income | 8,018 | 23 | 1,040 | 1,063 | 9,834 | 1,097 | (3,138) | 16,874 |
| Interest and similar expense | (4,235) | - | (527) | (527) | (7,316) | (1,835) | 3,138 | (10,775) |
| Net interest income | 3,783 | 23 | 513 | 536 | 2,518 | (738) | - | 6,099 |
| Other income (net of fee and commission expense) | 1,797 | 554 | 7,643 | 8,197 | 1,773 | 362 | - | 12,129 |
| Total income | 5,580 | 577 | 8,156 | 8,733 | 4,291 | (376) | - | 18,228 |
| Insurance claims | - | (302) | (7,220) | (7,522) | - | - | - | (7,522) |
| Total income, net of insurance claims | 5,580 | 275 | 936 | 1,211 | 4,291 | (376) | - | 10,706 |
| Operating expenses | (2,624) | (154) | (501) | (655) | (2,282) | (6) | - | (5,567) |
| Trading surplus (deficit) | 2,956 | 121 | 435 | 556 | 2,009 | (382) | - | 5,139 |
| Impairment | (1,224) | - | - | - | (572) | - | - | (1,796) |
| Profit on sale of businesses | - | - | 272 | 272 | 385 | - | - | 657 |
| Profit (loss) before tax | 1,732 | 121 | 707 | 828 | 1,822 | (382) | - | 4,000 |
| External revenue | 9,132 | 1,235 | 8,854 | 10,089 | 10,082 | 300 | - | 29,603 |
| Inter-segment revenue | 1,012 | 49 | 181 | 230 | 1,559 | 1,302 | (4,103) | - |
| Segment revenue | 10,144 | 1,284 | 9,035 | 10,319 | 11,641 | 1,602 | (4,103) | 29,603 |
| External assets | 115,012 | 1,164 | 72,213 | 73,377 | 163,294 | 1,663 | - | 353,346 |
| Inter-segment assets | 5,093 | 361 | 3,777 | 4,138 | 91,246 | 64,654 | (165,131) | - |
| Total assets | 120,105 | 1,525 | 75,990 | 77,515 | 254,540 | 66,317 | (165,131) | 353,346 |
| External liabilities | 96,166 | 870 | 65,304 | 66,174 | 162,376 | 16,205 | - | 340,921 |
| Inter-segment liabilities | 20,321 | 12 | 5,930 | 5,942 | 86,159 | 52,709 | (165,131) | - |
| Total liabilities | 116,487 | 882 | 71,234 | 72,116 | 248,535 | 68,914 | (165,131) | 340,921 |
| Other segment items: | | | | | | | | |
| Capital expenditure | 80 | 11 | 452 | 463 | 613 | 178 | - | 1,334 |
| Depreciation and amortisation | 205 | 14 | 37 | 51 | 374 | - | - | 630 |
| Defined benefit scheme charges | 114 | 3 | 26 | 29 | 92 | (60) | - | 175 |

Notes to the group accounts

3 Segmental analysis continued

| | UK Retail Banking £m | General insurance £m | Life, pensions and asset management £m | Insurance and Investments £m | Wholesale and International Banking £m | Central group items £m | Inter-segment eliminations £m | Total £m |
|--------------------------------------------------|----------------------------|----------------------------|-------------------------------------------------|---------------------------------------|----------------------------------------------------|---------------------------------|-------------------------------------|-------------|
| Year ended 31 December 2006 | | | | | | | | |
| Interest and similar income | 6,913 | 24 | 820 | 844 | 8,598 | 994 | (3,241) | 14,108 |
| Interest and similar expense | (3,271) | – | (741) | (741) | (6,421) | (1,587) | 3,241 | (8,779) |
| Net interest income | 3,642 | 24 | 79 | 103 | 2,177 | (593) | – | 5,329 |
| Other income (net of fee and commission expense) | 1,621 | 594 | 9,893 | 10,487 | 2,035 | 201 | – | 14,344 |
| Total income | 5,263 | 618 | 9,972 | 10,590 | 4,212 | (392) | – | 19,673 |
| Insurance claims | – | (200) | (8,369) | (8,569) | – | – | – | (8,569) |
| Total income, net of insurance claims | 5,263 | 418 | 1,603 | 2,021 | 4,212 | (392) | – | 11,104 |
| Operating expenses | (2,476) | (157) | (481) | (638) | (2,264) | 77 | – | (5,301) |
| Trading surplus (deficit) | 2,787 | 261 | 1,122 | 1,383 | 1,948 | (315) | – | 5,803 |
| Impairment | (1,238) | – | – | – | (308) | (9) | – | (1,555) |
| Profit (loss) before tax | 1,549 | 261 | 1,122 | 1,383 | 1,640 | (324) | – | 4,248 |
| External revenue | 8,136 | 1,249 | 10,888 | 12,137 | 8,659 | 158 | – | 29,090 |
| Inter-segment revenue | 698 | 19 | 199 | 218 | 2,276 | 910 | (4,102) | – |
| Segment revenue | 8,834 | 1,268 | 11,087 | 12,355 | 10,935 | 1,068 | (4,102) | 29,090 |
| External assets | 108,381 | 1,115 | 84,959 | 86,074 | 147,836 | 1,307 | – | 343,598 |
| Inter-segment assets | 3,331 | 502 | 4,050 | 4,552 | 80,995 | 53,588 | (142,466) | – |
| Total assets | 111,712 | 1,617 | 89,009 | 90,626 | 228,831 | 54,895 | (142,466) | 343,598 |
| External liabilities | 87,327 | 875 | 77,633 | 78,508 | 150,779 | 15,477 | – | 332,091 |
| Inter-segment liabilities | 20,980 | 54 | 5,595 | 5,649 | 72,793 | 43,044 | (142,466) | – |
| Total liabilities | 108,307 | 929 | 83,228 | 84,157 | 223,572 | 58,521 | (142,466) | 332,091 |
| Other segment items: | | | | | | | | |
| Capital expenditure | 82 | 7 | 845 | 852 | 647 | 143 | – | 1,724 |
| Depreciation and amortisation | 202 | 9 | 29 | 38 | 379 | – | – | 619 |
| Defined benefit scheme charges | 121 | 4 | 24 | 28 | 100 | (140) | – | 109 |

As the activities of the Group are predominantly carried out in the UK, no geographical analysis is presented.

4 Net interest income

| | Weighted average effective interest rate | | 2007 £m | 2006 £m |
|--------------------------------------------------------|------------------------------------------|-----------|-----------------|------------|
| | 2007 % | 2006 % | | |
| Interest receivable: | | | | |
| Loans and advances to customers | 6.89 | 6.21 | 13,209 | 10,853 |
| Loans and advances to banks | 5.14 | 4.72 | 2,025 | 1,826 |
| Lease and hire purchase receivables | 6.34 | 5.97 | 602 | 622 |
| Interest receivable on loans and receivables | 6.58 | 5.94 | 15,836 | 13,301 |
| Available-for-sale financial assets | 4.83 | 4.39 | 1,038 | 807 |
| Total interest receivable | 6.44 | 5.82 | 16,874 | 14,108 |
| Interest payable: | | | | |
| Deposits from banks | 5.00 | 4.67 | (1,919) | (1,680) |
| Customer accounts | 3.58 | 2.91 | (5,085) | (3,738) |
| Debt securities in issue | 5.08 | 4.67 | (2,680) | (1,983) |
| Subordinated liabilities | 5.65 | 5.72 | (741) | (694) |
| Liabilities under sale and repurchase agreements | 4.81 | 4.35 | (155) | (260) |
| Interest payable on liabilities held at amortised cost | 4.24 | 3.71 | (10,580) | (8,355) |
| Other | 4.28 | 9.68 | (195) | (424) |
| Total interest payable | 4.24 | 3.82 | (10,775) | (8,779) |
| Net interest income | | | 6,099 | 5,329 |

Included within interest receivable is £395 million (2006: £297 million) in respect of impaired financial assets. Net interest income also includes a credit of £1 million (2006: charge of £1 million) transferred from the cash flow hedging reserve (note 41).

5 Net fee and commission income

| | 2007 £m | 2006 £m |
|--------------------------------------|--------------|------------|
| Fee and commission income: | | |
| Current accounts | 693 | 652 |
| Insurance broking | 648 | 629 |
| Credit and debit card fees | 536 | 493 |
| Trust and other fiduciary fees | 362 | 331 |
| Other | 985 | 1,011 |
| | 3,224 | 3,116 |
| Fee and commission expense | (600) | (638) |
| Net fee and commission income | 2,624 | 2,478 |

As discussed in note 1(d), fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 4. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 6.

Certain fees payable by the Group's asset finance business have been reclassified to interest income as part of the effective yield of the related lending; there is no impact upon profit before tax. Comparative figures have been restated accordingly.

Notes to the group accounts

6 Net trading income

| | 2007 £m | 2006 £m |
|------------------------------------------------|------------|------------|
| Foreign exchange translation gains | 34 | 32 |
| Gains on foreign exchange trading transactions | 159 | 98 |
| Total foreign exchange | 193 | 130 |
| Investment property (losses) gains (note 21) | (321) | 631 |
| Securities and other gains | 3,251 | 5,580 |
| | 3,123 | 6,341 |

Securities and other gains comprise net gains arising on assets and liabilities held at fair value through profit or loss and for trading as follows:

| | 2007 £m | 2006 £m |
|------------------------------------------------------------------------------------------------------------------|------------|------------|
| Net income arising on assets held at fair value through profit or loss: | | |
| Loans and advances to banks and customers | 23 | 29 |
| Debt securities | 673 | 1,181 |
| Equity shares | 2,422 | 4,046 |
| Total net income arising on assets held at fair value through profit or loss | 3,118 | 5,256 |
| Net (expense) income arising on liabilities held at fair value through profit or loss – debt securities in issue | (153) | 21 |
| Total net gains arising on assets and liabilities held at fair value through profit or loss | 2,965 | 5,277 |
| Net gains on financial instruments held for trading | 286 | 303 |
| Securities and other gains | 3,251 | 5,580 |

7 Insurance premium income

| | 2007 £m | 2006 £m |
|-------------------------------------------|------------|------------|
| Life insurance | | |
| Gross premiums | 4,937 | 4,308 |
| Ceded reinsurance premiums | (98) | (189) |
| Net earned premiums | 4,839 | 4,119 |
| Non-life insurance | | |
| Gross premiums written | 632 | 608 |
| Ceded reinsurance premiums | (23) | (17) |
| Net premiums | 609 | 591 |
| Change in provision for unearned premiums | (18) | 9 |
| Net earned premiums | 591 | 600 |
| Total net earned premiums | 5,430 | 4,719 |

Life insurance gross written premiums can be further analysed as follows:

| | 2007 £m | 2006 £m |
|----------------|------------|------------|
| Life | 1,998 | 1,831 |
| Pensions | 2,235 | 1,780 |
| Annuities | 689 | 681 |
| Other | 15 | 16 |
| Gross premiums | 4,937 | 4,308 |

7 Insurance premium income continued

Non-life insurance gross written premiums can be further analysed as follows:

| | 2007 £m | 2006 £m |
|-------------------|------------|------------|
| Credit protection | 212 | 203 |
| Home | 412 | 394 |
| Health | 8 | 11 |
| | 632 | 608 |

8 Other operating income

| | 2007 £m | 2006 £m |
|--------------------------------------------------------------------------------|------------|------------|
| Operating lease rental income | 393 | 422 |
| Rental income from investment property (note 21) | 227 | 313 |
| Other rents receivable | 31 | 28 |
| Gains less losses on disposal of available-for-sale financial assets (note 41) | 5 | 22 |
| Movement in value of in-force business (note 23) | (93) | (199) |
| Other income | 389 | 220 |
| | 952 | 806 |

9 Insurance claims

Insurance claims comprise:

| | 2007 £m | 2006 £m |
|--------------------------------------------------------------|--------------|--------------|
| Life insurance and participating investment contracts | | |
| Claims and surrenders: | | |
| Gross | 5,432 | 5,375 |
| Reinsurers' share | (73) | (76) |
| | 5,359 | 5,299 |
| Change in liabilities: | | |
| Gross | 1,955 | 2,923 |
| Reinsurers' share | 20 | (18) |
| | 1,975 | 2,905 |
| Change in unallocated surplus (note 33) | (114) | 165 |
| Total life insurance and participating investment contracts | 7,220 | 8,369 |
| Non-life insurance | | |
| Claims and claims paid: | | |
| Gross | 250 | 198 |
| Reinsurers' share | - | - |
| | 250 | 198 |
| Change in liabilities: | | |
| Gross | 58 | 2 |
| Reinsurers' share | (6) | - |
| | 52 | 2 |
| Total non-life insurance | 302 | 200 |
| Total insurance claims expense | 7,522 | 8,569 |
| Life insurance gross claims can also be analysed as follows: | | |
| Deaths | 296 | 286 |
| Maturities | 1,516 | 1,385 |
| Surrenders | 2,994 | 3,081 |
| Annuities | 568 | 558 |
| Other | 58 | 65 |
| | 5,432 | 5,375 |

A non-life insurance claims development table is included in note 31.

Notes to the group accounts

10 Operating expenses

| | 2007 £m | 2006 £m |
|--------------------------------------------------------------|--------------|--------------|
| Salaries | 2,127 | 2,117 |
| Social security costs | 167 | 161 |
| Pensions and other post-retirement benefit schemes (note 35) | 238 | 165 |
| Other staff costs | 372 | 298 |
| Staff costs | 2,904 | 2,741 |
| Other administrative expenses: | | |
| Operating lease rentals | 250 | 254 |
| Repairs and maintenance | 154 | 165 |
| Communications and data processing | 462 | 499 |
| Advertising | 192 | 184 |
| Professional fees | 279 | 231 |
| Settlement of overdraft claims (see below) | 76 | – |
| Other | 620 | 608 |
| | 2,033 | 1,941 |
| Depreciation of tangible fixed assets (note 25) | 594 | 602 |
| Amortisation of other intangible assets (note 24) | 36 | 17 |
| Total operating expenses | 5,567 | 5,301 |

During the year ended 31 December 2007, operating expenses include a charge of £76 million (2006: £nil) relating to the settlement of customer claims for the repayment of overdraft fees, together with related costs.

The average number of persons on a headcount basis employed by the Group during the year was as follows:

| | 2007 | 2006 |
|----------|---------------|---------------|
| UK | 67,616 | 74,079 |
| Overseas | 1,937 | 2,013 |
| | 69,553 | 76,092 |

During the year the auditors earned the following fees:

| | 2007 £m | 2006 £m |
|------------------------------------------------------------------------|-------------|-------------|
| Fees payable for the audit of the Company's current year annual report | 6.8 | 6.0 |
| Fees payable for other services: | | |
| Audit of the Company's subsidiaries pursuant to legislation | 2.5 | 2.9 |
| Other services supplied pursuant to legislation | 2.7 | 4.7 |
| Total audit fees | 12.0 | 13.6 |
| Other services – audit related fees | 1.1 | 1.4 |
| Total audit and audit related fees | 13.1 | 15.0 |
| Services relating to taxation | 0.7 | 0.6 |
| Other non-audit fees: | | |
| Services relating to corporate finance transactions | 0.7 | 1.0 |
| Other services | 0.1 | 0.4 |
| Total other non-audit fees | 0.8 | 1.4 |
| Total fees payable to the Company's auditors by the Group | 14.6 | 17.0 |

10 Operating expenses continued

During the year, the auditors also earned fees payable by entities outside the consolidated Lloyds TSB Group in respect of the following:

| | 2007 £m | 2006 £m |
|--------------------------------------------------------------------------------------------------------|------------|------------|
| Audits of Group pension schemes | 0.2 | 0.2 |
| Audits of the unconsolidated Open Ended Investment Companies managed by the Group | 0.4 | 0.4 |
| Reviews of the financial position of corporate and other borrowers | 2.8 | 1.6 |
| Acquisition due diligence and other work performed in respect of potential venture capital investments | 0.6 | 1.0 |

Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group's Form 20-F filing.

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings.

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements.

Services relating to taxation: This category includes tax compliance and tax advisory services.

Other non-audit fees: This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to the provision of advice on tax issues, assistance in transactions involving the acquisition and disposal of businesses and accounting advice. The auditors are not permitted to provide management consultancy services to the Group.

The Group has procedures that are designed to ensure auditor independence, including that fees for audit and non-audit services are approved in advance. This approval can be obtained either on an individual engagement basis or, for certain types of non-audit services, particularly those of a recurring nature, through the approval of a fee cap covering all engagements of that type provided the fee is below that cap. All statutory audit work as well as non-audit assignments where the fee is expected to exceed the relevant fee cap must be pre-approved by the audit committee on an individual engagement basis. On a quarterly basis, the audit committee receives a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

11 Impairment

| | 2007 £m | 2006 £m |
|-------------------------------------------------------------|------------|------------|
| Impairment losses on loans and advances (note 19) | 1,721 | 1,560 |
| Other credit risk provisions (note 37) | 5 | (5) |
| | 1,726 | 1,555 |
| Impairment of available-for-sale financial assets (note 20) | 70 | – |
| Total impairment charged to the income statement | 1,796 | 1,555 |

12 Profit on sale of businesses

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------------------|------------|------------|
| Profit on sale of Lloyds TSB Registrars | 407 | – |
| Profit on sale of Abbey Life | 272 | – |
| Other, including adjustments in respect of businesses sold in prior years | (22) | – |
| | 657 | – |

During 2007 the Group completed the following transactions:

- The sale, announced on 21 May 2007, of the business and assets of Lloyds TSB Bank plc's company registration business, Lloyds TSB Registrars.
- The sale, announced on 31 July 2007, of Abbey Life Assurance Company Limited, a UK life operation which has been closed to new business since 2000.
- The sale, announced on 3 October 2007, of The Dutton-Forshaw Group Limited, a medium-size car dealership.

In addition, provision has been made for payments under an indemnity given in relation to a business sold in an earlier year.

The businesses sold in 2007 did not represent separate material lines of business and consequently they have not been treated as discontinued operations.

13 Taxation

(a) Analysis of charge for the year

| | 2007 £m | 2006 £m |
|---------------------------------------|------------|------------|
| UK corporation tax: | | |
| Current tax on profit for the year | 763 | 1,024 |
| Adjustments in respect of prior years | (30) | (137) |
| | 733 | 887 |
| Double taxation relief | (60) | (195) |
| | 673 | 692 |
| Foreign tax: | | |
| Current tax on profit for the year | 98 | 83 |
| Adjustments in respect of prior years | (3) | (8) |
| | 95 | 75 |
| Current tax charge | 768 | 767 |
| Deferred tax (note 36) | (89) | 574 |
| | 679 | 1,341 |

The charge for tax on the profit for the year is based on a UK corporation tax rate of 30 per cent (2006: 30 per cent).

The Group, as a proxy for policyholders in the UK, is required to record taxes on investment income, gains and losses each year. Accordingly, the tax attributable to UK life insurance policyholder earnings is included in income tax expense. The tax credit attributable to policyholders was £243 million (2006: £222 million expense), including a prior year tax charge of £5 million (2006: tax charge of £12 million).

In addition to the income statement current tax charge, a total of £131 million of current tax has been credited to equity (2006: a total of £17 million charged to equity); a credit of £3 million (2006: a credit of £15 million) in respect of share based payments, a credit of £103 million (2006: a charge of £33 million) in respect of foreign exchange differences and a net credit of £25 million (2006: a net credit of £1 million) in respect of the revaluation of available-for-sale financial assets.

(b) Factors affecting the tax charge for the year

A reconciliation of the charge that would result from applying the standard UK corporation tax rate to profit before tax to the tax charge for the year is given below:

| | 2007 £m | 2006 £m |
|------------------------------------------------------|------------|------------|
| Profit before tax | 4,000 | 4,248 |
| Tax charge thereon at UK corporation tax rate of 30% | 1,200 | 1,274 |
| Factors affecting charge: | | |
| Disallowed and non-taxable items | 2 | (8) |
| Overseas tax rate differences | (4) | (2) |
| Gains exempted or covered by capital losses | (274) | (78) |
| Policyholder interests | (173) | 123 |
| UK corporation tax rate change | (110) | – |
| Other items | 38 | 32 |
| Tax on profit on ordinary activities | 679 | 1,341 |
| Effective rate | 17.0% | 31.6% |

The effective tax rate of the Group excluding the gross policyholder and Open Ended Investment Company interests from profit before tax and the tax charge and, in 2007, the profit on disposal of businesses from profit before tax and the impact on the year end deferred tax position of the UK corporation tax rate change was 28.3 per cent (2006: 28.0 per cent).

14 Earnings per share

Basic earnings per share are calculated by dividing the net profit attributable to shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 5 million (2006: 5 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

| | 2007 | 2006 |
|-----------------------------------------------------|----------------|---------|
| Profit attributable to equity shareholders | £3,289m | £2,803m |
| Weighted average number of ordinary shares in issue | 5,637m | 5,616m |
| Basic earnings per share | 58.3p | 49.9p |

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares. The Company has dilutive potential ordinary shares in respect of share options and awards granted to employees. The number of shares that could have been acquired at market price (determined as the average annual share price of the Company's shares) based on the monetary value of the subscription rights attached to outstanding share options and awards is determined; the residual bonus shares are added to the weighted average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

| | 2007 | 2006 |
|---------------------------------------------------------------------------|----------------|---------|
| Profit attributable to equity shareholders | £3,289m | £2,803m |
| Weighted average number of ordinary shares in issue | 5,637m | 5,616m |
| Adjustment for share options and awards | 46m | 51m |
| Weighted average number of ordinary shares for diluted earnings per share | 5,683m | 5,667m |
| Diluted earnings per share | 57.9p | 49.5p |

The weighted average number of anti-dilutive share options and awards excluded from the calculation of diluted earnings per share was 3 million at 31 December 2007 (2006: 7 million).

15 Trading and other financial assets at fair value through profit or loss

| | 2007 £m | 2006 £m |
|-------------------------------------------------------------|---------------|---------------|
| Trading assets | 4,663 | 5,756 |
| Other financial assets at fair value through profit or loss | 53,248 | 61,939 |
| | 57,911 | 67,695 |

These assets are comprised as follows:

| | 2007 | | 2006 | |
|---------------------------------------------------|-------------------------|----------------------------------------------------------------------------|-------------------------|----------------------------------------------------------------------------|
| | Trading assets £m | Other financial assets at fair value through profit or loss £m | Trading assets £m | Other financial assets at fair value through profit or loss £m |
| Loans and advances to banks | 29 | 1 | 34 | 3 |
| Loans and advances to customers | 756 | 403 | 350 | 448 |
| Debt securities: | | | | |
| Government securities | 62 | 4,848 | 180 | 8,626 |
| Other public sector securities | - | - | - | 44 |
| Bank and building society certificates of deposit | - | 811 | - | 573 |
| Mortgage backed securities | 87 | 70 | 451 | 87 |
| Other asset backed securities | 122 | 1,805 | 595 | 861 |
| Corporate and other debt securities | 3,607 | 13,564 | 4,146 | 13,170 |
| | 3,878 | 21,098 | 5,372 | 23,361 |
| Equity shares: | | | | |
| Listed | - | 23,598 | - | 29,275 |
| Unlisted | - | 8,148 | - | 8,852 |
| | - | 31,746 | - | 38,127 |
| | 4,663 | 53,248 | 5,756 | 61,939 |

At 31 December 2007 £55,729 million (2006: £65,122 million) of trading and other financial assets at fair value through profit or loss had a contractual residual maturity of greater than one year.

Other financial assets at fair value through profit or loss represent the following assets designated into that category:

- (i) financial assets backing insurance contracts and investment contracts which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise;
- (ii) certain loans and advances to customers which are economically hedged by interest rate derivatives which are not in hedge accounting relationships and where significant measurement inconsistencies would otherwise arise if the related derivatives were treated as trading liabilities and the loans and advances were carried at amortised cost; and
- (iii) certain private equity investments that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2007 of the loans and advances to banks and customers designated at fair value through profit or loss was £404 million (31 December 2006: £451 million); the Group does not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk; this is determined by reference to the publicly available credit ratings of the instruments involved.

The carrying value of assets that are subject to stock lending arrangements was £1,450 million at 31 December 2007 (2006: £1,781 million) all of which the secured party is permitted by contract or custom to sell or repledge.

16 Derivative financial instruments

The principal derivatives used by the Group are interest rate and exchange rate contracts; particular attention is paid to the liquidity of the markets and products in which the Group trades to ensure that there are no undue concentrations of activity and risk.

Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.

Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. As discussed in note 18, the Group also uses credit default swaps to synthetically securitise £1,572 million (2006: £961 million) of commercial banking loans, and, in combination with external funding, to securitise a further £2,753 million (2006: £nil) of commercial banking loans.

Equity derivatives are also used by the Group as part of its equity based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate.

| | Contract/notional amount £m | Fair value assets £m | Fair value liabilities £m |
|-------------------------------------------------------------|--------------------------------|-------------------------|------------------------------|
| 31 December 2007 | | | |
| Trading | | | |
| Exchange rate contracts: | | | |
| Spot, forwards and futures | 150,450 | 1,759 | 1,285 |
| Currency swaps | 30,214 | 803 | 680 |
| Options purchased | 7,609 | 157 | – |
| Options written | 6,988 | – | 149 |
| | 195,261 | 2,719 | 2,114 |
| Interest rate contracts: | | | |
| Interest rate swaps | 332,361 | 2,765 | 3,250 |
| Forward rate agreements | 102,274 | 36 | 34 |
| Options purchased | 33,147 | 171 | – |
| Options written | 22,976 | – | 171 |
| Futures | 35,571 | 1 | – |
| | 526,329 | 2,973 | 3,455 |
| Credit derivatives | 63,444 | 1,838 | 1,057 |
| Equity and other contracts | 4,439 | 865 | 156 |
| Total derivative assets/liabilities held for trading | | 8,395 | 6,782 |
| Hedging | | | |
| Derivatives designated as fair value hedges: | | | |
| Interest rate swaps (including swap options) | 50,734 | 263 | 460 |
| Derivatives designated as cash flow hedges: | | | |
| Interest rate swaps | 630 | 1 | 24 |
| Derivatives designated as net investment hedges: | | | |
| Cross currency swaps | 5,302 | – | 316 |
| Total derivative assets/liabilities held for hedging | | 264 | 800 |
| Total recognised derivative assets/liabilities | | 8,659 | 7,582 |

At 31 December 2007 £3,573 million of total recognised derivative assets and £4,112 million of total recognised derivative liabilities (2006: £3,068 million of assets and £3,412 million of liabilities) had a contractual residual maturity of greater than one year.

Notes to the group accounts

16 Derivative financial instruments continued

| | Contract/notional amount £m | Fair value assets £m | Fair value liabilities £m |
|------------------------------------------------------|-----------------------------------|----------------------------|---------------------------------|
| 31 December 2006 | | | |
| Trading | | | |
| Exchange rate contracts: | | | |
| Spot, forwards and futures | 116,255 | 794 | 1,432 |
| Currency swaps | 20,618 | 346 | 496 |
| Options purchased | 3,076 | 51 | – |
| Options written | 3,822 | – | 32 |
| | 143,771 | 1,191 | 1,960 |
| Interest rate contracts: | | | |
| Interest rate swaps | 331,852 | 2,980 | 3,149 |
| Forward rate agreements | 40,876 | 17 | 18 |
| Options purchased | 17,034 | 68 | – |
| Options written | 12,588 | – | 63 |
| Futures | 33,066 | – | 1 |
| | 435,416 | 3,065 | 3,231 |
| Credit derivatives | 13,212 | 25 | 39 |
| Equity and other contracts | 4,026 | 797 | 67 |
| Total derivative assets/liabilities held for trading | | 5,078 | 5,297 |
| Hedging | | | |
| Derivatives designated as fair value hedges: | | | |
| Cross currency interest rate swaps | 80 | 10 | – |
| Interest rate swaps (including swap options) | 37,298 | 333 | 453 |
| | 37,378 | 343 | 453 |
| Derivatives designated as cash flow hedges: | | | |
| Interest rate swaps | 569 | 5 | 13 |
| Derivatives designated as net investment hedges: | | | |
| Cross currency swaps | 2,589 | 139 | – |
| Total derivative assets/liabilities held for hedging | | 487 | 466 |
| Total recognised derivative assets/liabilities | | 5,565 | 5,763 |

17 Loans and advances to banks

| | 2007 £m | 2006 £m |
|-------------------------------------------|------------|------------|
| Lending to banks | 5,892 | 5,966 |
| Money market placements with banks | 28,953 | 34,673 |
| Total loans and advances to banks | 34,845 | 40,639 |
| Allowance for impairment losses (note 19) | – | (1) |
| | 34,845 | 40,638 |

At 31 December 2007 £5,773 million (2006: £15,259 million) of loans and advances to banks had a contractual residual maturity of greater than one year.

The Group holds collateral with a fair value of £9,109 million (2006: £6,837 million), which it is permitted to sell or repledge, of which £8,482 million (2006: £6,209 million) was repledged or sold to third parties for periods not exceeding three months from the transfer.

18 Loans and advances to customers

| | 2007 £m | 2006 £m |
|-------------------------------------------|----------------|----------------|
| Agriculture, forestry and fishing | 3,226 | 2,905 |
| Energy and water supply | 2,102 | 2,024 |
| Manufacturing | 8,385 | 7,513 |
| Construction | 2,871 | 2,332 |
| Transport, distribution and hotels | 11,573 | 10,490 |
| Postal and telecommunications | 946 | 831 |
| Property companies | 17,576 | 12,896 |
| Financial, business and other services | 29,707 | 22,999 |
| Personal: | | |
| Mortgages | 102,739 | 95,601 |
| Other | 22,988 | 23,025 |
| Lease financing | 4,686 | 4,802 |
| Hire purchase | 5,423 | 5,060 |
| | 212,222 | 190,478 |
| Allowance for impairment losses (note 19) | (2,408) | (2,193) |
| | 209,814 | 188,285 |

At 31 December 2007 £153,302 million (2006: £141,247 million) of loans and advances to customers had a contractual residual maturity of greater than one year.

The Group holds collateral with a fair value of £1,975 million (2006: £444 million), which it is permitted to sell or repledge, of which £1,818 million (2006: £238 million) was repledged or sold to third parties for periods not exceeding three months from the transfer.

Loans and advances to customers include finance lease receivables, which may be analysed as follows:

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------------------------|----------------|----------------|
| Gross investment in finance leases, receivable: | | |
| Not later than 1 year | 620 | 637 |
| Later than 1 year and not later than 5 years | 1,917 | 2,358 |
| Later than 5 years | 5,339 | 5,358 |
| | 7,876 | 8,353 |
| Unearned future finance income on finance leases | (2,875) | (2,945) |
| Rentals received in advance | (131) | (163) |
| Commitments for expenditure in respect of equipment to be leased | (184) | (443) |
| Net investment in finance leases | 4,686 | 4,802 |
| The net investment in finance leases represents amounts recoverable as follows: | | |
| Not later than 1 year | 340 | 234 |
| Later than 1 year and not later than 5 years | 1,004 | 1,232 |
| Later than 5 years | 3,342 | 3,336 |
| | 4,686 | 4,802 |

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £16 million (2006: £7 million). The unguaranteed residual values included in finance lease receivables were as follows:

| | 2007 £m | 2006 £m |
|----------------------------------------------|------------|------------|
| Not later than 1 year | – | – |
| Later than 1 year and not later than 5 years | 17 | – |
| Later than 5 years | 159 | 168 |
| Total | 176 | 168 |

18 Loans and advances to customers continued

Securitisations

Loans and advances to customers include balances that have been securitised but not derecognised, comprising both residential mortgages and commercial banking loans, the carrying values of which are set out below together with any related liabilities. Residential mortgages are not derecognised because the Group remains exposed to the majority of the risk of any default in respect of them; commercial banking loans are not derecognised because the Group has not transferred the contractual rights to receive the cash flows from those loans nor has it assumed a contractual obligation to pay the cash flows from those loans to a third party.

Beneficial interests in certain residential mortgages have been transferred to special purpose entities which issue floating rate debt securities. Neither the Group nor any entities in the Group are obliged to support any losses that may be suffered by the note holders and do not intend to offer such support. The floating rate note holders only receive payments of interest and principal to the extent that the special purpose entities have received sufficient funds from the transferred mortgages and after certain expenses have been met. In the event of a deficiency, they have no recourse whatsoever to the Group.

At 31 December 2007 the total amount of residential mortgages subject to securitisation was £46,284 million (2006: £14,927 million) in respect of which external funding at the year end amounted to £12,403 million (2006: £10,048 million); external funding is shown in debt securities in issue (see note 30). The Group participates in the securitisation through the provision of administration and other services, the provision of interest rate and currency swaps and in the form of unsecured loan financing which is subordinate to the interests of the floating rate note holders.

In addition the Group has entered into two securitisations of its commercial banking loans as follows:

- a synthetic securitisation of £1,572 million (2006: £961 million) utilising credit default swaps (CDSs);
- a securitisation of £2,753 million (2006: £nil) utilising a combination of CDSs and £98 million (2006: £nil) of external funding.

The CDSs are accounted for as derivatives and are included in derivative financial instruments (see note 16) and the external funding is shown in debt securities in issue (see note 30).

19 Allowance for impairment losses on loans and advances

| | Loans and advances to customers | | | | Loans and advances to banks £m | Total £m |
|------------------------------------------------------|---------------------------------|----------------------|-----------------|-------------|-----------------------------------|-------------|
| | Retail – mortgages £m | Retail – other £m | Wholesale £m | Total £m | | |
| Balance at 1 January 2006 | 36 | 1,655 | 381 | 2,072 | 1 | 2,073 |
| Exchange and other adjustments | 1 | – | (14) | (13) | – | (13) |
| Adjustments on disposal of businesses and portfolios | – | (27) | – | (27) | – | (27) |
| Advances written off | (9) | (1,338) | (142) | (1,489) | – | (1,489) |
| Recoveries of advances written off in previous years | 2 | 170 | 18 | 190 | – | 190 |
| Unwinding of discount | – | (100) | – | (100) | – | (100) |
| Charge to the income statement | 12 | 1,558 | (10) | 1,560 | – | 1,560 |
| At 31 December 2006 | 42 | 1,918 | 233 | 2,193 | 1 | 2,194 |
| Exchange and other adjustments | – | – | 2 | 2 | – | 2 |
| Advances written off | (25) | (1,439) | (78) | (1,542) | – | (1,542) |
| Recoveries of advances written off in previous years | 2 | 133 | 2 | 137 | – | 137 |
| Unwinding of discount | – | (101) | (3) | (104) | – | (104) |
| Charge to the income statement | 18 | 1,518 | 186 | 1,722 | (1) | 1,721 |
| At 31 December 2007 | 37 | 2,029 | 342 | 2,408 | – | 2,408 |

The analysis of allowances for impairment between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 1(j). All impaired loans which exceed a certain threshold, principally within the Group's corporate banking business, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security. Included in loans and advances to customers were loans and advances individually determined to be impaired whose gross amount before impairment allowances was £684 million (2006: £428 million) and in respect of which collateral with a fair value of £193 million (2006: £186 million) was held.

20 Available-for-sale financial assets

| | 2007 £m | 2006 £m |
|---------------------------------------------------|---------------|------------|
| Debt securities: | | |
| Government securities | 319 | 393 |
| Other public sector securities | 5 | 189 |
| Bank and building society certificates of deposit | 1,825 | 1,615 |
| Mortgage backed securities | 6,050 | 5,662 |
| Other asset backed securities | 4,071 | 4,721 |
| Corporate and other debt securities | 6,270 | 4,817 |
| | 18,540 | 17,397 |
| Equity shares: | | |
| Listed | 1 | 1 |
| Unlisted | 28 | 14 |
| | 29 | 15 |
| Treasury bills and other bills: | | |
| Treasury bills and similar securities | 1,608 | 1,743 |
| Other bills | 19 | 23 |
| | 1,627 | 1,766 |
| | 20,196 | 19,178 |

At 31 December 2007 £15,265 million (2006: £13,779 million) of available-for-sale financial assets had a contractual residual maturity of greater than one year.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 1 (j). Included in available-for-sale assets at 31 December 2007 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £75 million and in respect of which no collateral was held.

The movement in available-for-sale financial assets is summarised as follows:

| | Carrying value before allowances for impairment £m | Allowances for impairment £m | Balance sheet value £m |
|------------------------------------------------|-------------------------------------------------------------|------------------------------------|------------------------------|
| At 1 January 2006 | 14,940 | – | 14,940 |
| Exchange and other adjustments | (1,116) | – | (1,116) |
| Additions | 23,448 | – | 23,448 |
| Disposals | (18,106) | – | (18,106) |
| Amortisation of premiums and discounts | 22 | – | 22 |
| Changes in fair value (note 41) | (10) | – | (10) |
| At 31 December 2006 | 19,178 | – | 19,178 |
| Exchange and other adjustments | (715) | – | (715) |
| Additions | 21,667 | – | 21,667 |
| Disposals | (19,468) | – | (19,468) |
| Amortisation of premiums and discounts | 36 | – | 36 |
| Changes in fair value (note 41) | (483) | – | (483) |
| Impairment transferred from reserves (note 41) | 70 | (70) | – |
| Disposal of businesses | (19) | – | (19) |
| At 31 December 2007 | 20,266 | (70) | 20,196 |

21 Investment property

| | 2007 £m | 2006 £m |
|-----------------------------------------------|--------------|------------|
| At 1 January | 4,739 | 4,260 |
| Exchange and other adjustments | 5 | – |
| Additions: | | |
| Acquisitions of new properties | 302 | 675 |
| Additional expenditure on existing properties | 181 | 75 |
| Total additions | 483 | 750 |
| Disposals | (271) | (902) |
| Adjustments on deconsolidation of OEICs | (881) | – |
| Changes in fair value (note 6) | (321) | 631 |
| Disposal of businesses | (32) | – |
| At 31 December | 3,722 | 4,739 |

During the year the percentage ownership of certain OEICs changed so that the Group no longer has control; as a consequence these OEICs have been deconsolidated.

Notes to the group accounts

21 Investment property continued

The investment properties are valued at least annually at open-market value, by independent, professionally qualified valuers, who have recent experience in the location and categories of the investment properties being valued.

| | | |
|-------------------------------------------------------------------------------------------------------------|-------------------|------------|
| In addition, the following amounts have been recognised in the income statement: | 2007 £m | 2006 £m |
| Rental income | 227 | 313 |
| Direct operating expenses arising from investment properties that generate rental income | 24 | 24 |
| Capital expenditure in respect of investment properties: | 2007 £m | 2006 £m |
| Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements | 111 | 85 |

22 Goodwill

| | | |
|-------------------------------|-------------------|------------|
| | 2007 £m | 2006 £m |
| At 1 January | 2,377 | 2,373 |
| Acquisitions (note 48) | – | 4 |
| Disposals | (19) | – |
| At 31 December | 2,358 | 2,377 |
| Cost* | 2,364 | 2,383 |
| Accumulated impairment losses | (6) | (6) |
| | 2,358 | 2,377 |

*For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,358 million (2006: £2,377 million), £1,836 million (or 78 per cent of the total) has been allocated to Scottish Widows and £510 million (or 22 per cent of the total) to Asset Finance.

The recoverable amount of Scottish Widows has been based on a value in use calculation. The calculation uses projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 11 per cent (gross of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of Asset Finance has also been based on a value in use calculation using cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 12 per cent (gross of tax). The discount rate has been set at a premium over the Group's weighted average cost of capital to take into account the specific risk profile of the Asset Finance business. The cash flows for each of the businesses of Asset Finance beyond the five-year period are extrapolated using steady growth rates, in each case not exceeding 4 per cent nor the long-term average growth rates for the markets in which the respective businesses of Asset Finance participate.

23 Value of in-force business

The asset in the consolidated balance sheet and movement recognised in the income statement are as follows:

| | | |
|-------------------------------------------------------------------------|-------------------|------------|
| Gross value of in-force insurance and participating investment business | 2007 £m | 2006 £m |
| At 1 January | 2,723 | 2,922 |
| Movement in value of in-force business | (93) | (199) |
| Disposal of business | (412) | – |
| At 31 December | 2,218 | 2,723 |

Further information on the Group's life assurance business, including its available capital resources and regulatory capital requirements, the realistic value of its assets and liabilities and its capital sensitivities is given in note 31.

23 Value of in-force business continued

The principal features of the methodology and process used for determining key assumptions used in the calculation of the value of in-force business are set out below:

Economic assumptions

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn the risk-free rate and all cash flows are discounted at the risk-free rate.

A market consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date.

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 at 31 December:

| | 2007 % | 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-profits fund there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

Non-economic assumptions

Future maintenance expenses, mortality, morbidity, lapse and paid-up rate assumptions are based on an analysis of past experience and represent management's best estimate of likely future experience.

24 Other intangible assets

| | Customer lists £m | Software enhancements £m | Total £m |
|------------------------------------------|----------------------|-----------------------------|-------------|
| Cost: | | | |
| At 1 January 2006 | – | 147 | 147 |
| Additions | 54 | 51 | 105 |
| At 31 December 2006 | 54 | 198 | 252 |
| Additions | 3 | 47 | 50 |
| Disposals | – | (5) | (5) |
| At 31 December 2007 | 57 | 240 | 297 |
| Accumulated amortisation: | | | |
| At 1 January 2006 | – | 97 | 97 |
| Charge for the year | – | 17 | 17 |
| At 31 December 2006 | – | 114 | 114 |
| Charge for the year | 5 | 31 | 36 |
| Disposals | – | (2) | (2) |
| At 31 December 2007 | 5 | 143 | 148 |
| Balance sheet amount at 31 December 2007 | 52 | 97 | 149 |
| Balance sheet amount at 31 December 2006 | 54 | 84 | 138 |

Software enhancements principally comprise identifiable and directly associated internal staff and other costs.

Notes to the group accounts

25 Tangible fixed assets

| | Premises £m | Equipment £m | Operating lease assets £m | Total tangible fixed assets £m |
|------------------------------------------------|----------------|-----------------|---------------------------------|--------------------------------------|
| Cost: | | | | |
| At 1 January 2006 | 1,421 | 2,667 | 2,961 | 7,049 |
| Exchange and other adjustments | – | (3) | (96) | (99) |
| Additions | 92 | 286 | 552 | 930 |
| Disposals | (25) | (101) | (551) | (677) |
| At 31 December 2006 | 1,488 | 2,849 | 2,866 | 7,203 |
| Exchange and other adjustments | – | 2 | (24) | (22) |
| Adjustments on disposal of businesses | (53) | (89) | – | (142) |
| Adjustments on deconsolidation of subsidiaries | – | – | (1,015) | (1,015) |
| Additions | 60 | 286 | 549 | 895 |
| Disposals | (58) | (177) | (945) | (1,180) |
| At 31 December 2007 | 1,437 | 2,871 | 1,431 | 5,739 |
| Accumulated depreciation and impairment: | | | | |
| At 1 January 2006 | 601 | 1,796 | 361 | 2,758 |
| Exchange and other adjustments | (1) | (1) | (63) | (65) |
| Charge for the year | 82 | 248 | 272 | 602 |
| Disposals | (7) | (83) | (254) | (344) |
| At 31 December 2006 | 675 | 1,960 | 316 | 2,951 |
| Exchange and other adjustments | – | 2 | (3) | (1) |
| Adjustments on disposal of businesses | (11) | (35) | – | (46) |
| Adjustments on deconsolidation of subsidiaries | – | – | (86) | (86) |
| Charge for the year | 83 | 242 | 269 | 594 |
| Disposals | (29) | (162) | (321) | (512) |
| At 31 December 2007 | 718 | 2,007 | 175 | 2,900 |
| Balance sheet amount at 31 December 2007 | 719 | 864 | 1,256 | 2,839 |
| Balance sheet amount at 31 December 2006 | 813 | 889 | 2,550 | 4,252 |

At 31 December the future minimum rentals receivable under non-cancellable operating leases were as follows:

| | 2007 £m | 2006 £m |
|--------------------------|------------|------------|
| Receivable within 1 year | 259 | 431 |
| 1 to 5 years | 271 | 747 |
| Over 5 years | 9 | 30 |
| | 539 | 1,208 |

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2007 and 2006 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £113 million at 31 December 2007 (£120 million at 31 December 2006) is expected to be received under non-cancellable sub-leases of the Group's premises.

During the year the Group entered into an agreement which transferred control over a number of its leasing subsidiaries to third parties. These subsidiaries have been deconsolidated and, consequently, operating lease assets and related accumulated depreciation in the amounts of £1,015 million and £86 million respectively have been derecognised.

26 Other assets

| | 2007 £m | 2006 £m |
|------------------------------------------------|------------|------------|
| Assets arising from reinsurance contracts held | 350 | 451 |
| Deferred acquisition costs | 212 | 443 |
| Settlement balances | 205 | 285 |
| Other assets and prepayments | 4,296 | 3,500 |
| | 5,063 | 4,679 |

26 Other assets continued

At 31 December 2007 £1,781 million (2006: £1,521 million) of other assets had a contractual residual maturity of greater than one year.

| Deferred acquisition costs: | 2007 £m | 2006 £m |
|------------------------------------------------------------------------------|------------|------------|
| At 1 January | 443 | 429 |
| Acquisition costs deferred, net of amounts amortised to the income statement | (22) | 14 |
| Disposal of businesses and other adjustments | (209) | – |
| At 31 December | 212 | 443 |

27 Deposits from banks

The breakdown of deposits from banks between the domestic and international offices of the Group is set out below:

| | 2007 £m | 2006 £m |
|----------------------|------------|------------|
| Domestic: | | |
| Non-interest bearing | 101 | 89 |
| Interest bearing | 32,335 | 28,405 |
| | 32,436 | 28,494 |
| International: | | |
| Non-interest bearing | 46 | 31 |
| Interest bearing | 6,609 | 7,869 |
| | 6,655 | 7,900 |
| | 39,091 | 36,394 |

At 31 December 2007 £25 million (2006: £2,760 million) of deposits from banks had a contractual residual maturity of greater than one year.

Included in deposits from banks were deposits of £1,509 million (2006: £582 million) held as collateral, principally in relation to derivative contracts. The fair value of those deposits approximates the carrying amount.

28 Customer accounts

| | 2007 £m | 2006 £m |
|---------------------------------------|------------|------------|
| Non-interest bearing current accounts | 3,807 | 4,338 |
| Interest bearing current accounts | 45,726 | 43,064 |
| Savings and investment accounts | 71,905 | 66,151 |
| Other customer deposits | 35,117 | 25,789 |
| | 156,555 | 139,342 |

The breakdown of customer accounts between the domestic and international offices of the Group is set out below:

| | 2007 £m | 2006 £m |
|----------------------|------------|------------|
| Domestic: | | |
| Non-interest bearing | 3,407 | 4,002 |
| Interest bearing | 149,412 | 131,781 |
| | 152,819 | 135,783 |
| International: | | |
| Non-interest bearing | 400 | 336 |
| Interest bearing | 3,336 | 3,223 |
| | 3,736 | 3,559 |
| | 156,555 | 139,342 |

At 31 December £1,949 million (2006: £2,077 million) of customer accounts had a contractual residual maturity of greater than one year.

Included in customer accounts were deposits of £777 million (2006: £462 million) held as collateral, principally in relation to derivative contracts. The fair value of those deposits approximates the carrying amount.

29 Trading and other liabilities at fair value through profit or loss

| | 2007 £m | 2006 £m |
|-------------------------------------------------------------------------|--------------|--------------|
| Liabilities held at fair value through profit or loss (debt securities) | 3,107 | 1,156 |
| Trading liabilities | 99 | 28 |
| | 3,206 | 1,184 |

At 31 December 2007 £2,032 million (2006: £1,144 million) of trading and other liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2007 was £3,131 million, which was £24 million higher than the balance sheet carrying value (2006: £1,200 million, which was £44 million higher than the balance sheet carrying value). There was an £8 million (2006: £nil) decrease in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds TSB Bank plc, the issuing entity within the Group.

Liabilities held at fair value through profit or loss represent designated debt securities in issue which contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities.

30 Debt securities in issue

| | 2007 £m | 2006 £m |
|-----------------------------------|---------------|---------------|
| Euro medium-term note programme | 4,692 | 5,650 |
| Other bonds and medium-term notes | 14,497 | 10,157 |
| Certificates of deposit issued | 14,995 | 25,244 |
| Commercial paper | 17,388 | 13,067 |
| Total debt securities in issue | 51,572 | 54,118 |

At 31 December 2007 £18,604 million (2006: £15,020 million) of debt securities in issue had a contractual residual maturity of greater than one year.

Debt securities in issue at 31 December 2007 included £12,403 million (2006: £10,048 million) in respect of the securitisation of mortgages and £98 million (2006: £nil) in respect of the securitisation of commercial banking loans (see note 18).

31 Liabilities arising from insurance contracts and participating investment contracts

| | 2007 £m | 2006 £m |
|-----------------------------------------------|---------------|---------------|
| Insurance contract liabilities | 23,189 | 26,350 |
| Participating investment contract liabilities | 14,874 | 15,095 |
| | 38,063 | 41,445 |

At 31 December 2007 £35,603 million (2006: £38,297 million) of liabilities arising from insurance contracts and participating investment contracts had a contractual residual maturity of greater than one year.

Insurance contract liabilities

Insurance contract liabilities, substantially all of which relate to business written in the United Kingdom, are comprised as follows:

| | 2007 | | | 2006 | | |
|--------------------------------------|---------------|--------------------|---------------|---------------|--------------------|---------------|
| | Gross £m | Reinsurance* £m | Net £m | Gross £m | Reinsurance* £m | Net £m |
| Life insurance (see (i) below) | 22,526 | (340) | 22,186 | 25,763 | (425) | 25,338 |
| Non-life insurance (see (ii) below): | | | | | | |
| Unearned premiums | 456 | - | 456 | 438 | - | 438 |
| Claims outstanding | 207 | (10) | 197 | 149 | (4) | 145 |
| | 663 | (10) | 653 | 587 | (4) | 583 |
| | 23,189 | (350) | 22,839 | 26,350 | (429) | 25,921 |

* Reinsurance balances receivable are reported within other assets (note 26).

31 Liabilities arising from insurance contracts and participating investment contracts continued**(i) Life insurance**

| The movement in life insurance contract liabilities over the year can be analysed as follows: | Gross £m | Reinsurance* £m | Net £m |
|-----------------------------------------------------------------------------------------------|-------------|--------------------|-----------|
| At 1 January 2006 | 25,888 | (511) | 25,377 |
| New business | 1,045 | (98) | 947 |
| Changes in existing business | (1,170) | 184 | (986) |
| At 31 December 2006 | 25,763 | (425) | 25,338 |
| New business | 2,428 | (18) | 2,410 |
| Changes in existing business | (1,316) | 15 | (1,301) |
| Disposal of businesses | (4,349) | 88 | (4,261) |
| At 31 December 2007 | 22,526 | (340) | 22,186 |

* Reinsurance balances receivable are reported within other assets (note 26).

| The movement in liabilities arising from participating investment contracts may be analysed as follows: | £m |
|---------------------------------------------------------------------------------------------------------|--------|
| At 1 January 2006 | 14,068 |
| New business | 1,815 |
| Changes in existing business | (788) |
| At 31 December 2006 | 15,095 |
| New business | 491 |
| Changes in existing business | (712) |
| At 31 December 2007 | 14,874 |

Process for determining key assumptions

The process for determining the key assumptions for insurance contracts and participating investment contracts is set out below.

These policy liabilities can be split into With Profit Fund liabilities, accounted for using the FSA's realistic capital regime (realistic liabilities) and Non-Profit Fund liabilities, accounted for using a traditional prospective actuarial discounted cash flow methodology as described in the accounting policies.

With Profit Fund realistic liabilities

The Group's With Profit Fund contains life insurance contracts and participating investment contracts. The calculation of With Profit Fund realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 23. The persistency rates used for the realistic valuation of the With Profit Fund liabilities make an allowance for potential changes in future experience as the guarantees and options within with-profits contracts become more valuable under adverse market conditions.

Other key assumptions are:

- Investment returns and discount rates

The realistic capital regime dictates that With Profit Fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The With Profit Fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as 0.1 per cent higher than the spot yields derived from the UK gilt yield curve.

- Guaranteed annuity option take-up rates

The guaranteed annuity option take-up rates are set with regard to the Group's actual experience and make allowance for potential increases in take-up rates when the Guaranteed Annuity Options become more valuable to the policyholder.

- Investment volatility

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical 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), with swaption volatility of broadly 11 per cent (31 December 2006: broadly 13 per cent).

- Mortality

The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

- Lapse rates

Lapse rates refer to the rate of policy termination and the rate at which policyholders stop paying regular premiums. These rates are based on a combination of historical experience and management's views on future experience taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions.

31 Liabilities arising from insurance contracts and participating investment contracts continued

Non-Profit Fund liabilities

Generally, assumptions used to value Non-Profit Fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of Non-Profit Fund liabilities are:

- Interest rates

The rates used are derived in accordance with the FSA Rules. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the FSA Rules, including reductions made to the available yields to allow for default risk based upon the credit rating of each stock.

- Mortality and morbidity

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation.

- Lapse rates

Lapse rates, set with regard to the Group's actual experience and with a margin for adverse deviation, are allowed for on some Non-Profit Fund contracts.

- Maintenance expenses

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

Key changes in assumptions

During 2007, following a detailed review of the Group's current and expected experience, there has been a change in the key assumption in respect of lapse rates. The impact of this change has been to decrease profit before tax by £52 million; this amount includes movements in liabilities and value of the in-force business in respect of insurance contracts and participating investment contracts.

Sensitivity analysis

The following table demonstrates the effect of changes in key assumptions on profit before tax disclosed in these financial statements assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. These amounts include movements in assets, liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts. The impact is shown in one direction but can be assumed to be reasonably symmetrical.

31 Liabilities arising from insurance contracts and participating investment contracts continued

| | Change in variable | Increase (reduction) in profit before tax £m |
|------------------------------------------------|--------------------|-------------------------------------------------|
| Non-annuitant mortality | 5% reduction | 28 |
| Annuitant mortality | 5% reduction | (90) |
| Lapse rates | 10% reduction | 47 |
| Maintenance expenses | 10% reduction | 79 |
| Risk-free rate ¹ | 0.25% deduction | 42 |
| Guaranteed annuity option take up ² | 5% addition | (4) |
| Equity investment volatility ³ | 1% addition | (5) |
| Widening of credit spreads ⁴ | 0.1% addition | (65) |

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

For the above sensitivities a 5 per cent reduction means a reduction to 95 per cent of the expected rate.

¹ This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

² This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

³ This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

⁴ 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.

ii) Non-life insurance

| Gross non-life insurance contract liabilities are analysed by line of business as follows: | 2007 £m | 2006 £m |
|--------------------------------------------------------------------------------------------|------------|------------|
| Credit protection | 274 | 268 |
| Home | 385 | 314 |
| Health | 4 | 5 |
| | 663 | 587 |

For non-life insurance contracts, the methodology and assumptions used in relation to determining the bases of the earned premium and claims provisioning levels are derived for each individual underwritten product. Assumptions are intended to be neutral estimates of the most likely or expected outcome. There has been no significant change in the assumptions and methodologies used for setting reserves.

The reserving methodology and associated assumptions are set out below:

The unearned premium reserve is determined on a basis that reflects the length of time for which contracts have been in force and the projected incidence of risk over the term of each contract.

Claims outstanding comprise those claims that have been notified and those that have been incurred but not reported. Claims incurred but not reported are determined based on the historical emergence of claims and their average cost. The notified claims element represents the best estimate of the cost of claims reported using projections and estimates based on historical experience.

The movements in non-life insurance contract liabilities and reinsurance assets over the year have been as follows:

| Provisions for unearned premiums | Gross £m | Reinsurance* £m | Net £m |
|----------------------------------|-------------|--------------------|-----------|
| At 1 January 2006 | 447 | – | 447 |
| Increase in the year | 608 | (17) | 591 |
| Release in the year | (617) | 17 | (600) |
| At 31 December 2006 | 438 | – | 438 |
| Increase in the year | 632 | (23) | 609 |
| Release in the year | (614) | 23 | (591) |
| At 31 December 2007 | 456 | – | 456 |

* Reinsurance balances receivable are reported within other assets (note 26).

These provisions represent the liability for short-term insurance contracts for which the Group's obligations are not expired at the year end.

31 Liabilities arising from insurance contracts and participating investment contracts continued

| Claims and loss adjustment expenses | Gross £m | Reinsurance* £m | Net £m |
|------------------------------------------|-------------|--------------------|-----------|
| Notified claims | 120 | (4) | 116 |
| Incurred but not reported | 27 | – | 27 |
| At 1 January 2006 | 147 | (4) | 143 |
| Cash paid for claims settled in the year | (223) | – | (223) |
| Increase (decrease) in liabilities: | | | |
| Arising from current year claims | 231 | – | 231 |
| Arising from prior year claims | (6) | – | (6) |
| At 31 December 2006 | 149 | (4) | 145 |
| Cash paid for claims settled in the year | (275) | – | (275) |
| Increase (decrease) in liabilities: | | | |
| Arising from current year claims | 341 | (9) | 332 |
| Arising from prior year claims | (8) | 3 | (5) |
| At 31 December 2007 | 207 | (10) | 197 |
| Notified claims | 188 | (10) | 178 |
| Incurred but not reported | 19 | – | 19 |
| At 31 December 2007 | 207 | (10) | 197 |
| Notified claims | 127 | (4) | 123 |
| Incurred but not reported | 22 | – | 22 |
| At 31 December 2006 | 149 | (4) | 145 |

* Reinsurance balances receivable are reported within other assets (note 26).

Non-life insurance claims development table

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

Non-life insurance all risks – gross

| Accident year | 2003 £m | 2004 £m | 2005 £m | 2006 £m | 2007 £m | Total £m |
|-----------------------------------------------|------------|------------|------------|------------|------------|-------------|
| Estimate of ultimate claims costs: | | | | | | |
| At end of accident year | 234 | 227 | 211 | 208 | 317 | 1,197 |
| One year later | 220 | 209 | 207 | 206 | | |
| Two years later | 223 | 207 | 204 | | | |
| Three years later | 221 | 206 | | | | |
| Four years later | 220 | | | | | |
| Current estimate of cumulative claims | 220 | 206 | 204 | 206 | 317 | 1,153 |
| Cumulative payments to date | (216) | (202) | (194) | (186) | (164) | (962) |
| Liability recognised in the balance sheet | 4 | 4 | 10 | 20 | 153 | 191 |
| Liability in respect of earlier years | | | | | | 6 |
| Total liability included in the balance sheet | | | | | | 197 |

The liability of £197 million shown in the above table excludes £10 million of unallocated claims handling expenses.

32 Liabilities arising from non-participating investment contracts

The movement in liabilities arising from non-participating investment contracts may be analysed as follows:

| | Gross £m | Reinsurance* £m | Net £m |
|------------------------------|-------------|--------------------|-----------|
| At 1 January 2006 | 21,839 | (33) | 21,806 |
| New business | 2,316 | – | 2,316 |
| Changes in existing business | 215 | 11 | 226 |
| At 31 December 2006 | 24,370 | (22) | 24,348 |
| New business | 2,413 | – | 2,413 |
| Changes in existing business | (1,303) | 22 | (1,281) |
| Disposal of businesses | (7,283) | – | (7,283) |
| At 31 December 2007 | 18,197 | – | 18,197 |

* Reinsurance balances receivable are reported within other assets (note 26).

At 31 December 2007 £17,929 million (2006: £23,449 million) of liabilities arising from non-participating investment contracts had a contractual residual maturity of greater than one year.

33 Unallocated surplus within insurance businesses

The movement in the unallocated surplus within long-term insurance business over the year can be analysed as follows:

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------------------|------------|------------|
| At 1 January | 683 | 518 |
| Change in unallocated surplus recognised in the income statement (note 9) | (114) | 165 |
| Disposal of businesses | (15) | – |
| At 31 December | 554 | 683 |

34 Other liabilities

| | 2007 £m | 2006 £m |
|----------------------------------------------------------|------------|------------|
| Settlement balances | 445 | 475 |
| Unitholders' interest in Open Ended Investment Companies | 3,441 | 4,583 |
| Other creditors and accruals | 5,804 | 5,927 |
| | 9,690 | 10,985 |

At 31 December 2007 £4,427 million (2006: £6,398 million) of other liabilities had a contractual residual maturity of greater than one year.

35 Retirement benefit obligations

| Charge to the income statement | 2007 £m | 2006 £m |
|-----------------------------------------|------------|------------|
| Defined benefit pension schemes | 158 | 104 |
| Other post-retirement benefit schemes | 17 | 5 |
| Total defined benefit schemes | 175 | 109 |
| Defined contribution pension schemes | 63 | 56 |
| | 238 | 165 |
| Amounts recognised in the balance sheet | 2007 £m | 2006 £m |
| Defined benefit pension schemes | 2,033 | 2,362 |
| Other post-retirement benefit schemes | 111 | 100 |
| | 2,144 | 2,462 |

35 Retirement benefit obligations continued

Pension schemes

Defined benefit schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas. The majority of the Group's employees are members of the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2. These schemes provide retirement benefits calculated as a percentage of final salary depending upon the length of service; the minimum retirement age under the rules of the schemes is 50.

The latest full valuations of the two main schemes were carried out as at 30 June 2005; these have been updated to 31 December 2007 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2007 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

The Group's obligations in respect of its defined benefit schemes are funded. The Group expects to pay contributions of some £500 million to its defined benefit schemes in 2008.

| Amount included in the balance sheet | 2007 £m | 2006 £m |
|----------------------------------------------------|--------------------|--------------------|
| Present value of funded obligations | 16,795 | 17,378 |
| Fair value of scheme assets | (16,112) | (15,279) |
| | 683 | 2,099 |
| Unrecognised actuarial gains | 1,350 | 263 |
| Liability in the balance sheet | 2,033 | 2,362 |
| Movements in the defined benefit obligation | 2007 £m | 2006 £m |
| At 1 January | 17,378 | 17,320 |
| Current service cost | 302 | 325 |
| Interest cost | 866 | 817 |
| Actuarial gains | (971) | (434) |
| Benefits paid | (555) | (555) |
| Past service cost | 25 | 32 |
| Curtailment | – | (129) |
| Disposal of businesses | (262) | – |
| Exchange and other adjustments | 12 | 2 |
| At 31 December | 16,795 | 17,378 |
| Changes in the fair value of scheme assets | 2007 £m | 2006 £m |
| At 1 January | 15,279 | 14,026 |
| Expected return | 1,035 | 942 |
| Employer contributions | 446 | 550 |
| Actuarial gains | 139 | 314 |
| Benefits paid | (555) | (555) |
| Disposal of businesses | (244) | – |
| Exchange and other adjustments | 12 | 2 |
| At 31 December | 16,112 | 15,279 |
| Actual return on scheme assets | 1,174 | 1,256 |

35 Retirement benefit obligations continued**Assumptions**

The principal actuarial and financial assumptions used in valuations of the defined benefit pension schemes were as follows:

| | 2007 % | 2006 % |
|----------------------------------------------------------------|-----------|-----------|
| Discount rate | 5.80 | 5.10 |
| Rate of inflation | 3.30 | 2.90 |
| Rate of salary increases | 4.00 | 3.93 |
| Rate of increase for pensions in payment and deferred pensions | 3.10 | 2.70 |

| | Years | Years |
|------------------------------------------------------------------------|-------|-------|
| Life expectancy for member aged 60, on the valuation date: | | |
| Men | 25.9 | 25.8 |
| Women | 27.9 | 27.8 |
| Life expectancy for member aged 60, 15 years after the valuation date: | | |
| Men | 27.1 | 27.0 |
| Women | 29.0 | 28.9 |

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2007 is assumed to live for, on average, 25.9 years for a male and 27.9 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

An analysis of the impact of a reasonable change in these assumptions is provided in note 2.

| The expected return on scheme assets has been calculated using the following assumptions: | 2007 % | 2006 % |
|-------------------------------------------------------------------------------------------|-----------|-----------|
| Equities | 8.0 | 8.0 |
| Fixed interest gilts | 4.6 | 4.1 |
| Index linked gilts | 4.2 | 3.9 |
| Non-government bonds | 5.1 | 4.8 |
| Property | 6.5 | 6.4 |
| Cash | 3.9 | 3.7 |

| The expected return on scheme assets in 2008 will be calculated using the following assumptions: | 2008 % |
|--------------------------------------------------------------------------------------------------|-----------|
| Equities and alternative assets | 8.2 |
| Fixed interest gilts | 4.5 |
| Index linked gilts | 4.4 |
| Non-government bonds | 6.0 |
| Property | 6.7 |
| Money market instruments and cash | 4.8 |

| Composition of scheme assets: | 2007 £m | 2006 £m |
|-----------------------------------|---------------|---------------|
| Equities | 8,537 | 9,677 |
| Fixed interest gilts | 2,041 | 1,114 |
| Index linked gilts | 1,433 | 921 |
| Non-government bonds | 1,990 | 1,543 |
| Property | 1,666 | 1,333 |
| Money market instruments and cash | 445 | 691 |
| At 31 December | 16,112 | 15,279 |

The assets of all the funded plans are held independently of the Group's assets in separate trustee administered funds.

The expected return on plan assets was determined by considering the expected returns available on the assets underlying the current investment policy. Expected yields on fixed interest investments are based on gross redemption yields at the balance sheet date at a term and credit rating broadly appropriate for the bonds held. Expected returns on equity and property investment are long-term rates based on the views of the plan's independent investment consultants. The expected return on equities allows for the different expected returns from the private equity, infrastructure and hedge fund investments held by some of the funded plans. Some of the funded plans also invest in certain money market instruments and the expected return on these investments has been assumed to be the same as cash.

Notes to the group accounts

35 Retirement benefit obligations continued

| Experience adjustments history (since the date of adoption of IAS 19): | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
|------------------------------------------------------------------------------------------|------------|------------|------------|------------|
| Present value of defined benefit obligation | 16,795 | 17,378 | 17,320 | 14,866 |
| Fair value of scheme assets | (16,112) | (15,279) | (14,026) | (11,648) |
| | 683 | 2,099 | 3,294 | 3,218 |
| Experience losses on scheme liabilities | (185) | (50) | (69) | (126) |
| Experience gains on scheme assets | 139 | 314 | 1,538 | 361 |
| The expense recognised in the income statement for the year ended 31 December comprises: | 2007 £m | | | 2006 £m |
| Current service cost | | 302 | | 325 |
| Interest cost | | 866 | | 817 |
| Expected return on scheme assets | | (1,035) | | (942) |
| Curtailement | | – | | (128) |
| Past service cost | | 25 | | 32 |
| Total defined benefit pension expense | | 158 | | 104 |

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.

Defined contribution schemes

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally the defined contribution sections of the Lloyds TSB Group Pension Schemes No's 1 and 2.

During the year ended 31 December 2007 the charge to the income statement in respect of these schemes was £63 million (2006: £56 million), representing the contributions payable by the employer in accordance with each scheme's rules.

Other post-retirement benefit schemes

The Group operates a number of schemes which provide post-retirement healthcare benefits to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2007; this valuation has been updated to 31 December 2007 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 7.43 per cent (2006: 7.02 per cent).

| Amount included in the balance sheet: | 2007 £m | 2006 £m |
|-------------------------------------------------------------|------------|------------|
| Present value of unfunded obligations | 123 | 110 |
| Unrecognised actuarial losses | (12) | (10) |
| Liability in the balance sheet | 111 | 100 |
| Movements in the other post-retirement benefits obligation: | 2007 £m | 2006 £m |
| At 1 January | 110 | 112 |
| Actuarial loss (gain) | 2 | (1) |
| Insurance premiums paid | (6) | (6) |
| Charge for the year | 17 | 5 |
| At 31 December | 123 | 110 |

36 Deferred tax

The movement in the net deferred tax balance is as follows:

| | 2007 £m | 2006 £m |
|-----------------------------------------------|------------|------------|
| At 1 January | 1,416 | 1,145 |
| Exchange and other adjustments | – | (3) |
| Disposals | (389) | (281) |
| Income statement (credit) charge: | | |
| Due to change in UK corporation tax rate | (110) | – |
| Other | 21 | 574 |
| | (89) | 574 |
| Amount charged (credited) to equity: | | |
| Available-for-sale financial assets (note 41) | (1) | – |
| Cash flow hedges (note 41) | (6) | – |
| Share based compensation | 17 | (19) |
| | 10 | (19) |
| At 31 December | 948 | 1,416 |

The 2007 Finance Act reduction in corporation tax rate from 30 per cent to 28 per cent resulted in a decrease in the Group's provision for deferred tax at 31 December 2007 of £110 million.

The deferred tax (credit) charge in the income statement comprises the following temporary differences:

| | 2007 £m | 2006 £m |
|---------------------------------------------|------------|------------|
| Accelerated capital allowances | (32) | 175 |
| Pensions and other post-retirement benefits | 134 | 134 |
| Investment reserve | (30) | 59 |
| Allowances for impairment losses | 42 | 22 |
| Unrealised gains | (91) | 162 |
| Tax on value of in-force business | (108) | (59) |
| Other temporary differences | (4) | 81 |
| | (89) | 574 |

Deferred tax assets and liabilities are comprised as follows:

| | 2007 £m | 2006 £m |
|---------------------------------------------|------------|------------|
| Deferred tax assets: | | |
| Pensions and other post-retirement benefits | (600) | (739) |
| Allowances for impairment losses | (101) | (143) |
| Other provisions | (15) | (39) |
| Derivatives | (178) | (161) |
| Tax losses carried forward | (409) | (326) |
| Other temporary differences | (169) | (255) |
| | (1,472) | (1,663) |

| | 2007 £m | 2006 £m |
|-----------------------------------|------------|------------|
| Deferred tax liabilities: | | |
| Accelerated capital allowances | 979 | 1,252 |
| Investment reserve | 119 | 149 |
| Unrealised gains | 342 | 500 |
| Tax on value of in-force business | 652 | 875 |
| Other temporary differences | 328 | 303 |
| | 2,420 | 3,079 |

Notes to the group accounts

36 Deferred tax continued

Deferred tax assets

Deferred tax assets are recognised for tax losses and foreign tax credit carry forwards to the extent that the realisation of the related tax benefit through future taxable profits is probable.

Deferred tax assets of £33 million (2006: £567 million) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition, deferred tax assets have not been recognised in respect of Eligible Unrelieved Foreign Tax (EUFT) and other foreign tax credits carried forward as at 31 December 2007 of £104 million (2006: £138 million), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. EUFT can be carried forward indefinitely.

Deferred tax liabilities

Deferred tax liabilities have not been recognised for tax that may be payable if earnings of certain subsidiaries were remitted to the UK. Such amounts are either reinvested for the foreseeable future or can be remitted free of tax. Unremitted earnings totalled £928 million (2006: £689 million).

Future transfers from Scottish Widows plc's long-term business funds to its Shareholder Fund will be subject to a shareholder tax charge. Under IAS 12, no provision is required to be made to the extent that the timing of such transfers is under Scottish Widows plc's control. Accordingly, deferred tax liabilities of £90 million (2006: £110 million) have not been recognised.

37 Other provisions

| | Provisions for contingent liabilities and commitments £m | Customer remediation provisions £m | Vacant leasehold property and other £m | Total £m |
|--------------------------------|----------------------------------------------------------------------|---------------------------------------------|----------------------------------------------------|-------------|
| At 1 January 2007 | 27 | 101 | 131 | 259 |
| Exchange and other adjustments | – | – | 6 | 6 |
| Provisions applied | (3) | (54) | (13) | (70) |
| Amortisation of discount | – | – | 3 | 3 |
| Charge for the year | 5 | – | 10 | 15 |
| Disposal of businesses | – | (4) | – | (4) |
| At 31 December 2007 | 29 | 43 | 137 | 209 |

Provisions for contingent liabilities and commitments

Provisions are held in cases where the Group is irrevocably committed to provide additional funds, but where there is doubt as to the potential borrower's ability to meet its repayment obligations.

Customer remediation provisions

In previous years, the Group has established provisions for the estimated cost of making redress payments to customers in respect of past product sales, in those cases where the original sales processes have been found to be deficient. During 2007 management have reviewed the adequacy of the provisions held having regard to current complaint volumes and the level of payments being made and are satisfied that no additional charge is required (no charge was made in 2006). At 31 December 2007 the remaining provisions held relate to past sales of a number of products, including mortgage endowment policies, sold through the branch networks of Lloyds TSB Bank, Lloyds TSB Scotland and Cheltenham & Gloucester and underwritten by life assurance companies within the Group and also by third parties. The principal assumptions that are made in the assessment of the adequacy of the provision relate to the number of cases that are likely to require redress, taking into account any time barring, and the estimated average cost per case. The ultimate cost and timing of the payments remains highly uncertain and will be influenced by external factors beyond the control of management, such as regulatory actions, media interest and the performance of the financial markets. However, it is expected that the majority of the remaining expenditure will be incurred over the next year.

Vacant leasehold property and other

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on an annual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging two years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

The Group also carries provisions in respect of its obligations relating to UIC Insurance Company Limited (UIC), which is in provisional liquidation. The Group has indemnified a third party against losses in the event that UIC does not honour its obligations under a reinsurance contract, which is subject to asbestosis and pollution claims in the US. The ultimate cost of settling the Group's exposure in respect of the insurance business of UIC and the timing remains uncertain. The provision held represents management's current best estimate of the cost after having regard to the financial condition of UIC and actuarial estimates of future claims.

38 Subordinated liabilities

| | Note | 2007 £m | 2006 £m |
|---------------------------------------------------------------------------------------------------|---------|---------------|---------------|
| Preferred securities | | | |
| 6.90% Perpetual Capital Securities (US\$1,000 million) | d, g | 471 | 483 |
| Fixed/Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million) | a, b | 593 | 587 |
| Fixed/Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million) | a, c | 515 | 504 |
| 6% Non-cumulative Redeemable Preference Shares | o | – | – |
| Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million) | d, m | 335 | 312 |
| 6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million) | d, f, k | 365 | 345 |
| Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million) | d, n | 248 | 248 |
| 4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million) | d, f, k | 504 | 478 |
| | | 3,031 | 2,957 |
| Undated subordinated liabilities | | | |
| Primary Capital Undated Floating Rate Notes: | d, e | | |
| Series 1 (US\$750 million) | | 374 | 383 |
| Series 2 (US\$500 million) | | 249 | 255 |
| Series 3 (US\$600 million) | | 299 | 306 |
| 11 ³ / ₄ % Perpetual Subordinated Bonds (£100 million) | | 100 | 100 |
| 5 ³ / ₈ % Undated Subordinated Step-up Notes callable 2009 (€1,250 million) | d, k | 915 | 845 |
| Undated Step-up Floating Rate Notes callable 2009 (€150 million) | d, e | 110 | 101 |
| 6 ⁵ / ₈ % Undated Subordinated Step-up Notes callable 2010 (£410 million) | d, j | 408 | 408 |
| 5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) | d, h | 534 | 525 |
| 5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million) | d, l | 111 | 107 |
| 5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million) | d, j | 449 | 475 |
| 6 ¹ / ₂ % Undated Subordinated Step-up Notes callable 2019 (£270 million) | d, j | 238 | 255 |
| 8% Undated Subordinated Step-up Notes callable 2023 (£200 million) | d, j | 188 | 189 |
| 6 ¹ / ₂ % Undated Subordinated Step-up Notes callable 2029 (£450 million) | d, j | 444 | 447 |
| 6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million) | d, j | 450 | 467 |
| | | 4,869 | 4,863 |
| Dated subordinated liabilities | | | |
| 7 ³ / ₄ % Subordinated Bonds 2007 (£300 million) | | – | 300 |
| 5 ¹ / ₄ % Subordinated Notes 2008 (DM 750 million) | | 281 | 260 |
| 10 ⁵ / ₈ % Guaranteed Subordinated Loan Stock 2008 (£100 million) | i | 100 | 100 |
| 9 ¹ / ₂ % Subordinated Bonds 2009 (£100 million) | | 100 | 99 |
| 6 ¹ / ₄ % Subordinated Notes 2010 (€400 million) | | 302 | 283 |
| 12% Guaranteed Subordinated Bonds 2011 (£100 million) | i | 100 | 100 |
| 9 ¹ / ₈ % Subordinated Bonds 2011 (£150 million) | | 149 | 149 |
| 4 ³ / ₄ % Subordinated Notes 2011 (€850 million) | | 609 | 562 |
| 5 ⁷ / ₈ % Subordinated Guaranteed Bonds 2014 (€750 million) | | 591 | 560 |
| 5 ⁷ / ₈ % Subordinated Notes 2014 (£150 million) | | 149 | 149 |
| 6 ⁵ / ₈ % Subordinated Notes 2015 (£350 million) | | 316 | 330 |
| Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million) | e | 300 | 300 |
| Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million) | e | 371 | 336 |
| Subordinated Floating Rate Notes 2020 (€100 million) | e | 73 | 67 |
| 5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million) | | 305 | 328 |
| 9 ⁵ / ₈ % Subordinated Bonds 2023 (£300 million) | | 312 | 329 |
| | | 4,058 | 4,252 |
| Total subordinated liabilities | | 11,958 | 12,072 |

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the period (2006: nil).

At 31 December 2007 £11,577 million (2006: £11,772 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

38 Subordinated liabilities continued

- a) Any repayment of preference shares would require prior notification to the Financial Services Authority. In certain circumstances, the shares may be mandatorily exchanged for qualifying non-innovative tier 1 securities. The Company may declare no dividend or a partial dividend on these preference shares. Dividends may be reduced if the distributable profits of the Company are insufficient to cover the payment in full of the dividends and also the payment in full of all other dividends on shares issued by the Company.
- b) Dividends will accrue at a rate of 6.369 per cent per annum up to 24 August 2015, and, unless redeemed, at a rate reset quarterly equal to 1.28 per cent per annum above the London interbank offered rate for three-month sterling deposits thereafter. These preference shares can be redeemed at the option of the Company on 25 August 2015 or quarterly thereafter.
- c) Dividends will accrue at a rate of 6.267 per cent per annum up to 13 November 2016 and, unless redeemed, at a rate reset quarterly equal to 1.035 per cent per annum above the London interbank offered rate for three-month sterling deposits thereafter. These preference shares can be redeemed at the option of the Company on 14 November 2016 or every 10 years thereafter.
- d) In certain circumstances, these notes, bonds and securities would acquire the characteristics of preference share capital. Any repayments of undated subordinated liabilities would require prior notification to the Financial Services Authority. They are accounted for as liabilities since coupon payments are mandatory as a consequence of the terms of the 6% Non-cumulative Redeemable Preference Shares.
- e) These notes bear interest at rates fixed periodically in advance based on London Interbank rates.
- f) In certain circumstances the interest payments on these securities can be deferred although in this case neither Lloyds TSB Bank plc nor Lloyds TSB Group plc can declare or pay a dividend until any deferred payments have been made. In the event of a winding up of Lloyds TSB Bank plc, these securities will acquire the characteristics of preference shares.
- g) In certain circumstances the interest payments on these securities can be deferred although in this case neither Lloyds TSB Bank plc nor Lloyds TSB Group plc can declare or pay a dividend until payments are resumed. Any deferred payments will be made good on redemption of the securities. The securities can be redeemed at par at the option of Lloyds TSB Bank plc on any coupon date.
- h) In certain circumstances the interest payments on these securities can be deferred although in this case Scottish Widows plc cannot declare or pay a dividend until any deferred payments have been made.
- i) Issued by a group undertaking under the Company's subordinated guarantee.
- j) At the callable date the coupon on these notes will be reset by reference to the applicable five year benchmark gilt rate.
- k) In the event that these notes are not redeemed at the callable date, the coupon will be reset to a floating rate.
- l) In the event that these notes are not redeemed at the callable date, the coupon will be reset to a margin of 1.60 per cent over the five year Yen swap rate.
- m) These securities constitute limited partnership interests in Lloyds TSB Capital 1 L.P., a Jersey limited partnership in which Lloyds TSB (General Partner) Limited, a wholly owned subsidiary, is the general partner. Non-cumulative income distributions accrue at a fixed rate of 7.375 per cent per annum up to 7 February 2012; thereafter they will accrue at a margin of 2.33 per cent over EURIBOR. This issue was made under the limited subordinated guarantee of Lloyds TSB Bank plc. In certain circumstances these preferred securities will be mandatorily exchanged for preference shares in Lloyds TSB Group plc. Lloyds TSB Group plc has entered into an agreement whereby dividends may only be paid on its ordinary shares if sufficient distributable profits are available for distributions due in the financial year on these preferred securities.
- n) These securities constitute limited partnership interests in Lloyds TSB Capital 2 L.P., a Jersey limited partnership in which Lloyds TSB (General Partner) Limited, a wholly owned subsidiary, is the general partner. Non-cumulative income distributions accrue at a fixed rate of 7.834 per cent per annum up to 7 February 2015; thereafter they will accrue at a margin of 3.50 per cent over a rate based on the yield of specified UK government stock. This issue was made under the limited subordinated guarantee of Lloyds TSB Bank plc. In certain circumstances these preferred securities will be mandatorily exchanged for preference shares in Lloyds TSB Group plc. Lloyds TSB Group plc has entered into an agreement whereby dividends may only be paid on its ordinary shares if sufficient distributable profits are available for distributions due in the financial year on these preferred securities.
- o) Throughout 2007 and 2006, the Company has had in issue 400 6 per cent non-cumulative preference shares of 25p each. The shares, which are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Company.

39 Share capital

| | 2007 | 2006 |
|-------------------------------------------------------|--------------|--------------|
| Authorised share capital | | |
| Sterling | £m | £m |
| 6,911 million Ordinary shares of 25p each | 1,728 | 1,728 |
| 79 million Limited voting ordinary shares of 25p each | 20 | 20 |
| 175 million Preference shares of 25p each | 44 | 44 |
| | 1,792 | 1,792 |
| US dollars | US\$m | US\$m |
| 160 million Preference shares of 25 cents each | 40 | 40 |
| Euro | €m | €m |
| 160 million Preference shares of 25 cents each | 40 | 40 |
| Japanese yen | ¥m | ¥m |
| 50 million Preference shares of ¥25 each | 1,250 | 1,250 |

39 Share capital continued

| Issued and fully paid ordinary shares | 2007 Number of shares | 2006 Number of shares | 2007 £m | 2006 £m |
|---------------------------------------------------|--------------------------|--------------------------|------------|------------|
| Ordinary shares of 25p each | | | | |
| At 1 January | 5,637,964,437 | 5,602,613,600 | 1,409 | 1,400 |
| Issued under employee share schemes | 9,739,508 | 35,350,837 | 3 | 9 |
| At 31 December | 5,647,703,945 | 5,637,964,437 | 1,412 | 1,409 |
| Limited voting ordinary shares of 25p each | | | | |
| At 1 January and 31 December | 78,947,368 | 78,947,368 | 20 | 20 |
| | | | 1,432 | 1,429 |

Share capital and control

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

- certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws); and
- pursuant to the UK Listing Authority's listing rules where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and
- pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. All of the Company's share plans contain provisions relating to a change of control. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights. Information regarding significant direct or indirect holdings of shares in the Company can be found on page 159.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary shares in accordance with the articles of association. The authority for the Company to purchase, in the market, 571,750,770 of its shares, representing some 10 per cent of the issued share capital, expires at the annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and entitled to vote has one vote for every share held. Further details regarding voting at the annual general meeting can be found in the notes to the notice of the annual general meeting.

Ordinary shares

The holders of ordinary shares (excluding the limited voting ordinary shares), who held 98.60 per cent of the total share capital as at 31 December 2007, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares (excluding the limited voting ordinary shares) may also receive a dividend (subject to the provisions of the Company's articles of association) and on a winding up may share in the assets of the Company.

Limited voting ordinary shares

The limited voting ordinary shares are held by the Lloyds TSB Foundations ('the Foundations'). The holders of the limited voting ordinary shares, who held 1.38 per cent of the total share capital as at 31 December 2007, are entitled to receive copies of every circular or other document sent out by the Company to the holders of other ordinary shares. These shares carry no rights to dividends but rank *pari passu* with the ordinary shares in respect of other distributions and in the event of winding up. These shares do not have any right to vote at general meetings other than on resolutions concerning acquisitions or disposals of such importance that they require shareholder consent, or for the winding up of the Company, or for a variation in the class rights of the limited voting ordinary shares. In the event of an offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting ordinary share will convert into an ordinary share and shall rank equally with the ordinary shares in all respects from the date of conversion. Lloyds TSB Group plc has entered into deeds of covenant with the Foundations, under the terms of which the Company makes annual donations to the Foundations equal, in total, to 1 per cent of the Group's pre-tax profits (after certain adjustments) averaged over three years. The deeds of covenant can be cancelled by the Company at nine years' notice. This donation is payable on or before the last day of February in each year ('the payment date'). In the event of conversion of the limited voting ordinary shares, the Foundations shall be entitled to receive a donation, on the same basis as set out above, on the payment date following conversion.

Issued and fully paid preference shares

Throughout 2006 and 2007, the Company has had in issue 400 6 per cent non-cumulative redeemable preference shares of 25p each. The shares, which are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Company. The holders of the 6 per cent non-cumulative redeemable preference shares held less than 0.1 per cent of the total share capital as at 31 December 2007. In accordance with IFRS, these shares are reported within liabilities.

In addition, during 2006 the Company issued 600,000 Fixed/Floating Rate Non-Cumulative Callable Preference Shares of 25 pence each with a liquidation preference of £1,000 per share and 1,000,000 Fixed/Floating Rate Non-Cumulative Callable Preference Shares of 25 cents each with a liquidation preference of US\$1,000 per share. Both issues of preference shares are perpetual, although the two issues can be redeemed at the option of the Company on or after 25 August 2015 and 14 November 2016 respectively and carry the right to non-cumulative dividends which are fixed until those first redemption dates. The terms of these two issues of preference shares are such that the Company cannot declare and pay a dividend on any other junior class of share (including the mandatory dividend on the 400 6 per cent non-cumulative redeemable preference shares mentioned above) until the coupon has been paid on these preference shares. As the Company is effectively committed to the payment of a coupon on these shares they are classified as liabilities on the balance sheet in accordance with IFRS (see note 38). The holders of the fixed/floating rate non-cumulative callable preference shares, who held less than 0.1 per cent of the total share capital as at 31 December 2007, do not have the right to receive notice of, attend, speak or vote at any general meetings other than on resolutions relating to the variation or abrogation of any of the rights or restrictions attached to the preference shares or the winding up or dissolution of the Company or if, at the date of the notice of meeting, the dividend payable at the immediately preceding dividend payment date has failed to be declared and paid in full. Upon winding up, the fixed/floating rate non-cumulative callable preference shares shall rank equally with the most senior class of preference shares and any other class of shares which are expressed to rank equally.

Notes to the group accounts

39 Share capital continued

Any repayment of the fixed/floating rate non-cumulative callable preference shares would require prior notification to the Financial Services Authority. The sterling fixed/floating rate non-cumulative callable preference shares can be redeemed at the option of the Company on or after 25 August 2015; at this call date, dividends will be reset at a margin of 1.28 per cent over 3 month LIBOR. The US dollar fixed/floating rate non-cumulative callable preference shares can be redeemed at the option of the Company on or after 14 November 2016; at this call date, dividends will be reset at a margin of 1.035 per cent over 3 month LIBOR. In certain circumstances, the fixed/floating rate non-cumulative callable preference shares may be mandatorily exchanged for qualifying non-innovative tier 1 securities and in certain circumstances and subject to compliance with certain requirements, the fixed/floating rate non-cumulative callable preference shares may be redeemed by the Company at certain times in the event that the FSA makes a decision that the preference shares can no longer qualify as non-innovative tier 1 capital. The Company may declare no dividend or a partial dividend on these preference shares; notwithstanding this discretion, in certain circumstances, the dividends on the fixed/floating rate non-cumulative callable preference shares will be mandatorily payable if the preference shares cease to be eligible to qualify as regulatory capital and the Company is in compliance with relevant FSA regulations regarding capital adequacy. Dividends may be reduced if the distributable profits of the Company are insufficient to cover the payment in full of the dividends and also the payment in full of all other dividends on shares issued by the Company. These securities were issued during 2006 primarily to finance the development and expansion of the business of the Group.

40 Share premium account

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------|------------|------------|
| At 1 January | 1,266 | 1,170 |
| Premium arising on issue of shares under share option schemes | 32 | 96 |
| At 31 December | 1,298 | 1,266 |

41 Other reserves

| | 2007 £m | 2006 £m |
|-----------------------------------------------------------------------|------------|------------|
| Other reserves comprise: | | |
| Merger reserve | 343 | 343 |
| Revaluation reserve in respect of available-for-sale financial assets | (399) | – |
| Cash flow hedging reserve | (3) | 12 |
| Foreign currency translation reserve | (1) | (19) |
| | (60) | 336 |

| Movements in other reserves were as follows: | 2007 £m | 2006 £m |
|----------------------------------------------|------------|------------|
|----------------------------------------------|------------|------------|

Merger reserve

| | | |
|------------------------------|-----|-----|
| At 1 January and 31 December | 343 | 343 |
|------------------------------|-----|-----|

Revaluation reserve in respect of available-for-sale financial assets

| | | |
|-------------------------------------------------------------|-------|------|
| At 1 January | – | 29 |
| Exchange and other adjustments | (1) | 2 |
| Change in fair value of available-for-sale financial assets | (483) | (10) |
| Deferred tax | 1 | – |
| Current tax | 46 | – |
| | (436) | (10) |
| Income statement transfer: | | |
| Disposals (note 8) | (5) | (22) |
| Impairment | 70 | – |
| Current tax | (21) | 1 |
| | 44 | (21) |
| Disposal of businesses | (6) | – |
| At 31 December | (399) | – |

41 Other reserves continued

| | 2007 £m | 2006 £m |
|----------------------------------------------------------|------------|------------|
| Cash flow hedging reserve | | |
| At 1 January | 12 | 11 |
| Change in fair value of hedging derivatives | (20) | – |
| Deferred tax | 6 | – |
| | (14) | – |
| Income statement transfer (note 4) | (1) | 1 |
| At 31 December | (3) | 12 |
| Foreign currency translation reserve | | |
| | 2007 £m | 2006 £m |
| At 1 January | (19) | 12 |
| Currency translation differences arising in the year | 257 | (108) |
| Foreign currency (losses) gains on net investment hedges | (342) | 110 |
| Current tax | 103 | (33) |
| | (239) | 77 |
| At 31 December | (1) | (19) |

42 Retained profits

| | 2007 £m | 2006 £m |
|------------------------------------------------------------|------------|------------|
| At 1 January | 8,124 | 7,210 |
| Profit for the year | 3,289 | 2,803 |
| Dividends | (1,957) | (1,919) |
| Purchase/sale of treasury shares | (1) | (35) |
| Employee share option schemes – value of employee services | 16 | 65 |
| At 31 December | 9,471 | 8,124 |

Retained profits are stated after deducting £75 million (2006: £87 million) representing 15 million (2006: 15 million) treasury shares held.

Value of employee services includes a credit of £30 million (2006: £31 million) reflecting the income statement charge in respect of SAYE and executive options, together with a related tax charge of £14 million (2006: tax credit £34 million). Purchase/sale of treasury shares includes a credit of £29 million (2006: £27 million) relating to the cost of other share scheme awards.

43 Ordinary dividends

| | 2007 Pence per share | 2006 Pence per share | 2007 £m | 2006 £m |
|---------------------------------------------------------------|-------------------------|-------------------------|------------|------------|
| Final dividend for previous year paid during the current year | 23.5 | 23.5 | 1,325 | 1,316 |
| Interim dividend | 11.2 | 10.7 | 632 | 603 |
| | 34.7 | 34.2 | 1,957 | 1,919 |

The directors have proposed a final dividend of 24.7 pence per share (2006: 23.5 pence per share) representing a total cost of £1,394 million (2006: £1,325 million) which will be paid on 7 May 2008.

The Bank of New York Nominees have waived the right to all dividends on the Lloyds TSB Group plc shares that they hold (holding at 31 December 2007: 10 shares, at 31 December 2006: 10 shares).

In addition, the trustees of the following holdings of Lloyds TSB Group plc shares in relation to employee share schemes retain the right to receive dividends but chose to waive their entitlement to the dividends on those shares as indicated: the Lloyds TSB Group Shareplan (holding at 31 December 2007: 931,478 shares, at 31 December 2006: 898,320 shares, waived right to all dividends), the Lloyds TSB Group Employee Share Ownership Trust (holding at 31 December 2007: 1,935,141 shares, at 31 December 2006: 1,138,311 shares, waived right to all dividends), Lloyds TSB Group Holdings (Jersey) Limited (holding at 31 December 2006 and 31 December 2007: 41,801 shares, waived right to all but a nominal amount of 1 penny in total) and the Lloyds TSB Qualifying Employee Share Ownership Trust (holding at 31 December 2006 and 31 December 2007: 1,364 shares, waived right to all but a nominal amount of 1 penny in total).

44 Share based payments

Charge to the income statement

The charge to the income statement is set out below:

| | 2007 £m | 2006 £m |
|--------------------------------|------------|------------|
| Executive and SAYE schemes: | | |
| Options granted in the year | 6 | 6 |
| Options granted in prior years | 24 | 25 |
| | 30 | 31 |
| Share incentive plan: | | |
| Shares granted in the year | 12 | 12 |
| Shares granted in prior years | 17 | 15 |
| | 29 | 27 |
| | 59 | 58 |

During the year ended 31 December 2007 the Group operated the following share based payment schemes, all of which are equity settled.

Executive schemes

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between April 2001 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5. Prior to 18 April 2001, the normal limit was equal to one year's remuneration and no performance multiplier was applied.

Performance conditions for executive options

For options granted up to March 2001

| Options granted | Performance conditions |
|--------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| March 1997 – August 1999 | Growth in earnings per share which is equal to the aggregate percentage change in the Retail Price Index plus two percentage points for each complete year of the relevant period together with a further condition that Lloyds TSB Group plc's ranking based on shareholder return (calculated by reference to both dividends and growth in share price) over the relevant period should be in the top fifty companies of the FTSE 100. |
| March 2000 – March 2001 | As for March 1997 – August 1999 except that there must have been growth in the earnings per share equal to the change in the Retail Price Index plus three percentage points for each complete year of the relevant period. |

In respect of options granted between March 1997 and March 2001, the relevant period for the performance conditions begins at the end of the financial year preceding the date of grant and will continue until the end of the third subsequent year following commencement or, if not met, the end of such later year in which the conditions are met. Once the conditions have been satisfied the options will remain exercisable without further conditions. If they are not satisfied by the tenth anniversary of the grant the option will lapse.

For options granted from August 2001 to August 2004

The performance condition is linked to the performance of Lloyds TSB Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds TSB Group plc.

The performance condition is measured over a three year period commencing at the end of the financial year preceding the grant of the option and continuing until the end of the third subsequent year. If the performance condition is not then met, it will be measured at the end of the fourth financial year. If the condition has not then been met, the options will lapse.

To meet the performance conditions, the Group's ranking against the comparator group must be at least ninth. The full grant of options will only become exercisable if the Group is ranked first. A performance multiplier (of between nil and 100 per cent) will be applied below this level to calculate the number of shares in respect of which options granted to executive directors will become exercisable, and will be calculated on a sliding scale. If Lloyds TSB Group plc is ranked below median the options will not be exercisable.

Options granted to senior executives other than executive directors are not so highly leveraged and, as a result, different performance multipliers are applied to their options. For the majority of executives, options are granted with the performance condition but no performance multiplier.

44 Share based payments continued

For options granted in 2005

The same conditions apply as for grants made up to August 2004, except that:

- the performance condition is linked to the performance of Lloyds TSB Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds TSB Group plc;
- if the performance condition has not been met at the end of the third subsequent year, the options will lapse; and
- the full grant of options becomes exercisable only if the Group is ranked in the top four places of the comparator group. A sliding scale applies between fourth and eighth positions. If Lloyds TSB Group is ranked below the median (ninth or below) the options will not be exercisable and will lapse.

Movements in the number of share options outstanding under the Executive share option schemes during 2006 and 2007 are set out below:

| | 2007 | | 2006 | |
|----------------------------|-------------------|-----------------------------------------|-------------------|-----------------------------------------|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | 32,459,593 | 459.84 | 43,977,411 | 485.35 |
| Exercised | (267,650) | 509.10 | (328,218) | 437.03 |
| Forfeited | (11,570,169) | 421.76 | (11,189,600) | 560.77 |
| Outstanding at 31 December | 20,621,774 | 480.57 | 32,459,593 | 459.84 |
| Exercisable at 31 December | 423,300 | 876.37 | 819,139 | 744.90 |

The weighted average share price at the time that the options were exercised during 2007 was 574.39 pence (2006: 552.29 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 6.2 years (2006: 6.8 years).

Save-As-You-Earn schemes

Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £250 per month and, at the expiry of a fixed term of three or five years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Group at a price equal to 80 per cent of the market price at the date the options were granted. Grants in periods up to 31 December 2001 also had options exercising after seven years.

Movements in the number of share options outstanding under the SAYE schemes are set out below:

| | 2007 | | 2006 | |
|----------------------------|-------------------|-----------------------------------------|-------------------|-----------------------------------------|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | 90,220,144 | 335.94 | 114,459,474 | 314.17 |
| Granted | 10,759,688 | 432.00 | 19,301,716 | 418.00 |
| Exercised | (9,473,792) | 351.28 | (35,148,982) | 294.84 |
| Forfeited | (3,447,524) | 363.45 | (3,440,257) | 339.47 |
| Cancelled | (1,822,417) | 397.98 | (3,984,599) | 427.14 |
| Expired | (562,872) | 547.46 | (967,208) | 503.13 |
| Outstanding at 31 December | 85,673,227 | 342.49 | 90,220,144 | 335.94 |
| Exercisable at 31 December | 1,560,472 | 459.01 | 889,479 | 475.41 |

The weighted average share price at the time that the options were exercised during 2007 was 552.20 pence (2006: 524.36 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 1.7 years (2006: 2.2 years).

The weighted average fair value of SAYE options granted during the year was £1.07 (2006: £1.00). The values for the SAYE options have been determined using a standard Black-Scholes model.

Notes to the group accounts

44 Share based payments continued

Other share option plans

Lloyds TSB Group Executive Share Plan 2003

The plan was adopted in December 2003 and under the plan share options may be granted to senior employees. Options granted to date under this scheme were granted specifically to facilitate recruitment. Options granted under this plan are not subject to any performance conditions.

| | 2007 | | 2006 | |
|----------------------------|-------------------|-----------------------------------------|-------------------|-----------------------------------------|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | 357,123 | Nil | 268,918 | Nil |
| Granted | 214,444 | Nil | 165,395 | Nil |
| Exercised | (203,170) | Nil | (77,190) | Nil |
| Forfeited | (59,679) | Nil | – | – |
| Outstanding at 31 December | 308,718 | Nil | 357,123 | Nil |

The weighted average fair value of options granted in the year was £5.27 (2006: £4.58). The weighted average share price at the time that the options were exercised during 2007 was 539.77 pence (2006: 557.25 pence). No options outstanding at 31 December were exercisable. The weighted average remaining contractual life of options outstanding at the end of the year was 1.8 years (2006: 2.0 years).

Lloyds TSB Group executive share plan 2005

This plan was adopted by the Group in 2005, specifically to facilitate the recruitment of Ms Dial. Ms Dial is the only participant in the plan. Options granted under this plan are not subject to any performance conditions and will normally become exercisable only if Ms Dial remains as an employee, and has not given notice of resignation, on 31 May 2008, or if Ms Dial ceases to be an employee before that date in certain circumstances described in her service agreement: in both cases the options will be exercisable for six months and then lapse.

| | 2007 | | 2006 | |
|------------------------------------------|-------------------|-----------------------------------------|-------------------|-----------------------------------------|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January and 31 December | 242,825 | Nil | 242,825 | Nil |

No options outstanding at 31 December were exercisable. The weighted average remaining contractual life of options outstanding at the end of the year was 0.9 years (2006: 1.9 years).

Long-Term Incentive Plan

The Long-Term Incentive Plan introduced in 2006 is a long-term incentive scheme aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Group over a three year period. Awards are made within limits set by the rules of the plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary, in exceptional circumstances this may increase up to four times annual salary.

The performance conditions for awards made in May and August 2006 are as follows:

- For 50 per cent of the award (the 'EPS Award') – the percentage increase in earnings per share of the Group (on a compound annualised basis) over the relevant period must be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the Retail Price Index over the same period. If it is less than 3 per cent per annum the EPS Award will lapse. If the increase is more than 3 per cent but less than 6 per cent per annum then the proportion of shares released will be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2006 and ends on 31 December 2008.
- For the other 50 per cent of the award (the 'TSR Award') – it will be necessary for the Group's total shareholder return (calculated by reference to both dividends and growth in share price) to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award will vest where the Group's total shareholder return is equal to median and vesting will occur on a straight line basis in between these points. Where the Group's total shareholder return is below the median of the comparator group, the TSR Award will lapse. The relevant period commenced on 1 January 2006 and ends on 31 December 2008.

The performance conditions for awards made in March and August 2007 are as follows:

- For 50 per cent of the award (the 'EPS Award') – the performance condition is as described for May 2006 with the relevant performance period commencing on 1 January 2007 and ending on 31 December 2009.
- For the other 50 per cent of the award (the 'TSR Award') – the performance condition is as described for May 2006 with the relevant performance period commencing on 8 March 2007 (the date of award) and ending on 7 March 2010.

| | 2007 | 2006 |
|----------------------------|------------------|------------------|
| | Number of shares | Number of shares |
| Outstanding at 1 January | 5,788,108 | – |
| Granted | 7,884,787 | 5,852,386 |
| Forfeited | (463,814) | (64,278) |
| Outstanding at 31 December | 13,209,081 | 5,788,108 |

The fair value of the share awards granted in 2007 was £3.13 (2006: £2.96).

44 Share based payments continued

Performance share plan

Under the performance share plan, introduced during 2005, participating executives will be eligible for an award of free shares, known as performance shares, to match the bonus shares awarded as part of their 2004 and 2005 bonus. The maximum match will be two performance shares for each bonus share, awarded at the end of a three year period. The actual number of shares awarded will depend on the Group's total shareholder return performance measured over a three year period, compared to other companies in the comparator group. The maximum of two performance shares for each bonus share will be awarded only if the Group's total shareholder return performance places it first in the comparator group; one performance share for each bonus share will be granted if the Group is placed fifth; and one performance share for every two bonus shares if the Group is placed eighth (median). Between first and fifth position, and fifth and eighth position, sliding scales will apply. If the total shareholder return performance is below median, no performance shares will be awarded. There will be no retest. Whilst income tax is deducted from the bonus before deferral into the plan, where a match of performance shares is justified, these shares will be awarded as if income tax had not been deducted.

| | 2007 Number of shares | 2006 Number of shares |
|----------------------------|--------------------------|--------------------------|
| Outstanding at 1 January | 1,849,102 | 826,438 |
| Granted | - | 1,035,564 |
| Forfeited | (81,508) | (12,900) |
| Outstanding at 31 December | 1,767,594 | 1,849,102 |

The fair value of the matching element of the performance shares awarded during 2006 was £1.92.

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

| | Executive schemes | | | SAYE schemes | | | Other share option plans | | |
|-------------------------|-----------------------------------------|-----------------------------------------|-------------------|-----------------------------------------|-----------------------------------------|-------------------|-----------------------------------------|-----------------------------------------|-------------------|
| | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options |
| 31 December 2007 | | | | | | | | | |
| Exercise price range | | | | | | | | | |
| £0 to £2 | - | - | - | - | - | - | Nil | 1.4 | 551,543 |
| £2 to £3 | - | - | - | 284.00 | 0.9 | 42,651,925 | - | - | - |
| £3 to £4 | - | - | - | 353.10 | 1.9 | 15,775,539 | - | - | - |
| £4 to £5 | 449.34 | 6.8 | 17,898,897 | 424.23 | 2.9 | 26,525,262 | - | - | - |
| £5 to £6 | 551.09 | 2.2 | 815,965 | 563.65 | 0.1 | 720,501 | - | - | - |
| £6 to £7 | 652.47 | 3.1 | 1,114,912 | - | - | - | - | - | - |
| £7 to £8 | - | - | - | - | - | - | - | - | - |
| £8 to £9 | 871.54 | 0.7 | 792,000 | - | - | - | - | - | - |

| | Executive schemes | | | SAYE schemes | | | Other share option plans | | |
|-------------------------|-----------------------------------------|-----------------------------------------|-------------------|-----------------------------------------|-----------------------------------------|-------------------|-----------------------------------------|-----------------------------------------|-------------------|
| | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options | Weighted average exercise price (pence) | Weighted average remaining life (years) | Number of options |
| 31 December 2006 | | | | | | | | | |
| Exercise price range | | | | | | | | | |
| £0 to £2 | - | - | - | - | - | - | Nil | 1.9 | 599,948 |
| £2 to £3 | - | - | - | 284.00 | 1.8 | 45,234,578 | - | - | - |
| £3 to £4 | 394.25 | 6.2 | 6,265,105 | 345.97 | 2.3 | 23,320,638 | - | - | - |
| £4 to £5 | 444.24 | 7.7 | 22,497,465 | 422.94 | 3.1 | 20,125,284 | - | - | - |
| £5 to £6 | 541.32 | 2.6 | 1,424,507 | 571.24 | 0.7 | 1,522,876 | - | - | - |
| £6 to £7 | 652.98 | 4.2 | 1,332,177 | - | - | - | - | - | - |
| £7 to £8 | - | - | - | 718.00 | 0.2 | 16,768 | - | - | - |
| £8 to £9 | 873.12 | 1.7 | 940,339 | - | - | - | - | - | - |

Notes to the group accounts

44 Share based payments continued

The fair value calculations at 31 December 2007 are based on the following assumptions:

| | SAYE | Other option schemes | Other share plans |
|---------------------------------|-----------|----------------------|-------------------|
| Risk-free interest rate | 5.35% | 5.46% | 5.19% |
| Expected life | 3.7 years | 1.4 years | 3.0 years |
| Expected volatility | 21% | 17% | 17% |
| Expected dividend yield | 6.3% | 6.0% | 6.3% |
| Weighted average share price | £5.40 | £5.73 | £5.41 |
| Weighted average exercise price | £4.32 | Nil | Nil |
| Expected forfeitures | 6% | 4% | 4% |

Expected volatility is a measure of the amount by which the Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

Share incentive plan

Free shares

An award of shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to maximum of £3,000. The percentage is normally announced concurrently with the Group's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf. The award is subject to a non-market based condition: if an employee leaves the Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited (for awards made up to April 2005, only a portion of the shares would be forfeited: 75 per cent within one year of the award, 50 per cent within two years and 25 per cent within three years).

The number of shares awarded relating to free shares in 2007 was 6,784,201 (2006: 7,725,195), with an average fair value of £5.82 (2006: £5.28), based on the market price at the date of award.

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these shares are held in trust for a mandatory period of three years on the employees' behalf. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason or the accompanying partnership shares are sold within that time, 100 per cent of the matching shares are forfeited (or the portion relating to the shares sold).

The number of shares awarded relating to matching shares in 2007 was 2,073,018 (2006: 2,036,423), with an average fair value of £5.49 (2006: £5.40), based on market prices at the date of award.

45 Related party transactions

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds TSB Group plc group executive committee together with its non-executive directors.

The table below details, on an aggregated basis, key management personnel compensation:

| | 2007 £m | 2006 £m |
|----------------------------------------|------------|------------|
| Compensation | | |
| Salaries and other short-term benefits | 15 | 14 |
| Post-employment benefits | 4 | 3 |
| Termination benefits | – | – |
| Share based payments | 4 | 3 |
| | 23 | 20 |

| | 2007 million | 2006 million |
|-----------------------------------------------------------|-----------------|-----------------|
| Share options | | |
| At 1 January | 11 | 12 |
| Granted (including options of appointed directors) | – | – |
| Exercised/lapsed (including options of retired directors) | (4) | (1) |
| At 31 December | 7 | 11 |

| | 2007 million | 2006 million |
|-------------------------------------------------------|-----------------|-----------------|
| Share incentive plans | | |
| At 1 January | 4 | 1 |
| Granted (including entitlements of appointees) | 2 | 3 |
| Exercised/lapsed (including entitlements of retirees) | – | – |
| At 31 December | 6 | 4 |

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Group and its key management personnel:

| | 2007 £m | 2006 £m |
|----------------|------------|------------|
| Loans | | |
| At 1 January | 2 | 3 |
| Advanced | 1 | – |
| Repayments | (1) | (1) |
| At 31 December | 2 | 2 |

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 4.95 per cent and 30.0 per cent in 2007 (2006: 5.1 per cent and 19.9 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2006: £nil).

| | 2007 £m | 2006 £m |
|-----------------|------------|------------|
| Deposits | | |
| At 1 January | 5 | 5 |
| Placed | 21 | 12 |
| Withdrawn | (21) | (12) |
| At 31 December | 5 | 5 |

Deposits placed by key management personnel attracted interest rates of up to 8.0 per cent (2006: 5.2 per cent).

At 31 December 2007, the Group provided guarantees totalling £6,154 in respect of one director (2006: £19,744 in respect of one director).

At 31 December 2007, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £2 million with five directors and three connected persons (2006: £2 million with four directors and four connected persons).

Notes to the group accounts

45 Related party transactions continued

Subsidiaries

Details of the principal subsidiaries are given in note 8 to the parent company financial statements. In accordance with IAS 27, transactions and balances with subsidiaries have been eliminated on consolidation.

Other related party disclosures

At 31 December 2007, the Group's pension funds had call deposits with Lloyds TSB Bank plc amounting to £23 million (2006: £19 million).

The Group manages 107 (2006: 89) Open Ended Investment Companies (OEICs), and of these 40 (2006: 38) are consolidated. The Group invested £1,961 million (2006: £372 million) and redeemed £1,526 million (2006: £237 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £2,233 million (2006: £1,746 million) at 31 December. The Group earned fees of £200 million from the unconsolidated OEICs (2006: £149 million). The Company held no investments in OEICs at any time during 2006 or 2007.

The Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2007, these companies had total assets of approximately £3,184 million (2006: £1,625 million), total liabilities of approximately £3,182 million (2006: £1,609 million) and for the year ended 31 December 2007 had turnover of £2,136 million (2006: £2,409 million) and made a net profit of approximately £9 million (2006: net loss of £5 million). In addition, the Group has provided £609 million (2006: £460 million) of financing to these companies on which it received £23 million (2006: £20 million) of interest income in the year.

46 Contingent liabilities and commitments

Legal proceedings

During the ordinary course of business the Group is subject to threatened or actual legal proceedings. All such material cases are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed properly to assess the merits of the case. No provisions are held against such cases; however the Group does not currently expect the final outcome of these cases to have a material adverse effect on its financial position.

On 27 July 2007, following agreement between the UK Office of Fair Trading (OFT) and a number of UK financial institutions, the OFT issued High Court legal proceedings against those institutions, including Lloyds TSB Bank plc, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to requests for unplanned overdrafts. A preliminary issues hearing has now taken place and judgement is currently awaited. It is likely that further hearings will be required and, if appeals are pursued, the proceedings may take a number of years to conclude. Pending resolution, the Financial Services Authority has agreed, subject to certain conditions, that the handling of customer complaints on this issue can be suspended until the proceedings are concluded unless in the light of prevailing circumstances this would be inappropriate. The Group intends strongly to defend its position. Accordingly, no provision in relation to the outcome of this litigation has been made. Depending on the Court's determinations, a range of outcomes is possible, some of which could have a significant financial impact on the Group. The ultimate impact of the litigation on the Group can only be known at its conclusion.

There has been increased scrutiny of the financial institutions sector, especially in the US, with respect to combating money laundering and terrorist financing and enforcing compliance with economic sanctions. The Office of Foreign Assets Control (OFAC) administers US laws and regulations in relation to US economic sanctions against designated foreign countries, nationals and others and the Group has been conducting a review of its conduct with respect to historic US dollar payments involving countries, persons or entities subject to those sanctions. The Group has provided information relating to its review of such historic payments to a number of authorities including OFAC, the US Department of Justice and the New York County District Attorney's office which, along with other authorities, have been reported to be conducting a broader review of sanctions compliance by non-US financial institutions. The Group is involved in ongoing discussions with these authorities with respect to agreeing a resolution of their investigations. No provision has been made in respect of this matter. The Group does not expect the final outcome to have a material adverse effect on its financial position.

Contingent liabilities and commitments arising from the banking business

Acceptances and endorsements arise where the Lloyds TSB Group agrees to guarantee payment on a negotiable instrument drawn up by a customer.

Other items serving as direct credit substitutes include standby letters of credit, or other irrevocable obligations, where the Lloyds TSB Group has an irrevocable obligation to pay a third party beneficiary if the customer fails to repay an outstanding commitment; they also include acceptances drawn under letters of credit or similar facilities where the acceptor does not have specific title to an identifiable underlying shipment of goods.

Performance bonds and other transaction-related contingencies (which include bid or tender bonds, advance payment guarantees, VAT Customs & Excise bonds and standby letters of credit relating to a particular contract or non-financial transaction) are undertakings where the requirement to make payment under the guarantee depends on the outcome of a future event.

Lloyds TSB Group's maximum exposure to loss is represented by the contractual nominal amount detailed in the table below. Consideration has not been taken of any possible recoveries from customers for payments made in respect of such guarantees under recourse provisions or from collateral held.

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------|--------------|--------------|
| Contingent liabilities | | |
| Acceptances and endorsements | 40 | 63 |
| Other: | | |
| Other items serving as direct credit substitutes | 1,095 | 618 |
| Performance bonds and other transaction-related contingencies | 2,429 | 2,096 |
| | 3,524 | 2,714 |
| | 3,564 | 2,777 |

46 Contingent liabilities and commitments continued

The contingent liabilities of the Group, as detailed above, arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

| | 2007 £m | 2006 £m |
|--------------------------------------------------------------------------------|------------|------------|
| Commitments | | |
| Documentary credits and other short-term trade-related transactions | 306 | 374 |
| Forward asset purchases and forward deposits placed | 463 | 5,764 |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | |
| Less than 1 year original maturity: | | |
| Mortgage offers made | 4,639 | 4,071 |
| Other commitments | 52,791 | 49,731 |
| | 57,430 | 53,802 |
| 1 year or over original maturity | 32,165 | 28,477 |
| | 90,364 | 88,417 |

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend £53,036 million (2006: £51,288 million) was irrevocable.

Operating lease commitments

Where a Group company is the lessee the future minimum lease payments under non-cancellable premises operating leases are as follows:

| | 2007 £m | 2006 £m |
|----------------------------------------------|------------|------------|
| Not later than 1 year | 212 | 212 |
| Later than 1 year and not later than 5 years | 677 | 733 |
| Later than 5 years | 764 | 835 |
| | 1,653 | 1,780 |

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

Capital commitments

Excluding commitments in respect of investment property (see note 21), capital expenditure contracted but not provided for at 31 December 2007 amounted to £102 million (2006: £75 million). Of this amount, £96 million (2006: £74 million) related to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

47 Financial risk management

As a bancassurer, financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; and liquidity risk. Information about the Group's exposure to each of the above risks, the Group's objectives, policies and processes for measuring and managing risk and the Group's management of capital can be found on pages 36 to 56. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

Measurement basis of financial assets and liabilities

The accounting policies in note 1 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

| | Derivatives designated as hedging instruments £m | At fair value through profit or loss | | Available- for-sale £m | Loans and receivables £m | Held at amortised cost £m | Insurance contracts £m | Total £m |
|-------------------------------------------------------------------------------------|--------------------------------------------------------------|-----------------------------------------|-------------------------------------------------|------------------------------|--------------------------------|------------------------------------|------------------------------|----------------|
| | | Held for trading £m | Designated upon initial recognition £m | | | | | |
| As at 31 December 2007 | | | | | | | | |
| Financial assets | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 4,330 | - | 4,330 |
| Items in the course of collection from banks | - | - | - | - | - | 1,242 | - | 1,242 |
| Trading and other financial assets at fair value through profit or loss | - | 4,663 | 53,248 | - | - | - | - | 57,911 |
| Derivative financial instruments | 264 | 8,395 | - | - | - | - | - | 8,659 |
| Loans and advances to banks | - | - | - | - | 34,845 | - | - | 34,845 |
| Loans and advances to customers | - | - | - | - | 209,814 | - | - | 209,814 |
| Available-for-sale financial assets | - | - | - | 20,196 | - | - | - | 20,196 |
| Total financial assets | 264 | 13,058 | 53,248 | 20,196 | 244,659 | 5,572 | - | 336,997 |
| Financial liabilities | | | | | | | | |
| Deposits from banks | - | - | - | - | - | 39,091 | - | 39,091 |
| Customer accounts | - | - | - | - | - | 156,555 | - | 156,555 |
| Items in course of transmission to banks | - | - | - | - | - | 668 | - | 668 |
| Trading and other liabilities at fair value through profit or loss | - | 99 | 3,107 | - | - | - | - | 3,206 |
| Derivative financial instruments | 800 | 6,782 | - | - | - | - | - | 7,582 |
| Debt securities in issue | - | - | - | - | - | 51,572 | - | 51,572 |
| Liabilities arising from insurance contracts and participating investment contracts | - | - | - | - | - | - | 38,063 | 38,063 |
| Liabilities arising from non-participating investment contracts | - | - | - | - | - | - | 18,197 | 18,197 |
| Unallocated surplus within insurance businesses | - | - | - | - | - | - | 554 | 554 |
| Subordinated liabilities | - | - | - | - | - | 11,958 | - | 11,958 |
| Total financial liabilities | 800 | 6,881 | 3,107 | - | - | 259,844 | 56,814 | 327,446 |

47 Financial risk management continued

| | Derivatives designated as hedging instruments £m | At fair value through profit or loss | | Available- for-sale £m | Loans and receivables £m | Held at amortised cost £m | Insurance contracts £m | Total £m |
|-------------------------------------------------------------------------------------|--------------------------------------------------------------|-----------------------------------------|-------------------------------------------------|------------------------------|--------------------------------|------------------------------------|------------------------------|----------------|
| | | Held for trading £m | Designated upon initial recognition £m | | | | | |
| As at 31 December 2006 | | | | | | | | |
| Financial assets | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 1,898 | - | 1,898 |
| Items in the course of collection from banks | - | - | - | - | - | 1,431 | - | 1,431 |
| Trading and other financial assets at fair value through profit or loss | - | 5,756 | 61,939 | - | - | - | - | 67,695 |
| Derivative financial instruments | 487 | 5,078 | - | - | - | - | - | 5,565 |
| Loans and advances to banks | - | - | - | - | 40,638 | - | - | 40,638 |
| Loans and advances to customers | - | - | - | - | 188,285 | - | - | 188,285 |
| Available-for-sale financial assets | - | - | - | 19,178 | - | - | - | 19,178 |
| Total financial assets | 487 | 10,834 | 61,939 | 19,178 | 228,923 | 3,329 | - | 324,690 |
| Financial liabilities | | | | | | | | |
| Deposits from banks | - | - | - | - | - | 36,394 | - | 36,394 |
| Customer accounts | - | - | - | - | - | 139,342 | - | 139,342 |
| Items in course of transmission to banks | - | - | - | - | - | 781 | - | 781 |
| Trading and other liabilities at fair value through profit or loss | - | 28 | 1,156 | - | - | - | - | 1,184 |
| Derivative financial instruments | 466 | 5,297 | - | - | - | - | - | 5,763 |
| Debt securities in issue | - | - | - | - | - | 54,118 | - | 54,118 |
| Liabilities arising from insurance contracts and participating investment contracts | - | - | - | - | - | - | 41,445 | 41,445 |
| Liabilities arising from non-participating investment contracts | - | - | - | - | - | - | 24,370 | 24,370 |
| Unallocated surplus within insurance businesses | - | - | - | - | - | - | 683 | 683 |
| Subordinated liabilities | - | - | - | - | - | 12,072 | - | 12,072 |
| Total financial liabilities | 466 | 5,325 | 1,156 | - | - | 242,707 | 66,498 | 316,152 |

Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There are a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However a significant proportion of the Group's lending assets, for example personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio. At 31 December 2007 the aggregate notional principal of interest rate swaps designated as fair value hedges was £50,734 million (2006: £37,378 million) with a net fair value liability of £197 million (2006: £110 million) (see note 16). The gains on the hedging instruments were £94 million (2006: losses of £288 million). The losses on the hedged items attributable to the hedged risk were £117 million (2006: gains of £266 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2007 was £630 million (2006: £569 million) with a net fair value liability of £23 million (2006: £8 million) (see note 16). In 2007, there is no ineffectiveness recognised in the income statement that arises from cash flow hedges (2006: nil). There were no transactions for which cash flow hedge accounting had to be ceased in 2007 or 2006 as a result of the highly probable cash flows no longer being expected to occur.

Notes to the group accounts

47 Financial risk management continued

Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

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. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to Wholesale and International Banking Market and Liquidity Risk. Associated VaR and the closing, average, maximum and minimum for 2006 and 2007 are disclosed on page 43.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to retained earnings.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using cross currency swaps. At 31 December 2007 the aggregate notional principal of these cross currency swaps was £5,302 million (2006: £2,589 million) with a net fair value liability of £316 million (2006: asset of £139 million) (see note 16) and they were designated on an after-tax basis as hedges of net investments in foreign operations. In 2007, there is no ineffectiveness recognised in the income statement that arises from net investment hedges (2006: nil).

The Group's main overseas operations are in the Americas and Europe. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

| | 2007 £m | 2006 £m |
|------------------------------------------|------------|------------|
| Functional currency of Group operations: | | |
| Euro | 95 | 76 |
| US dollar | 7 | 97 |
| Swiss franc | 70 | 70 |
| Other non-sterling | 208 | 188 |
| | 380 | 431 |

Credit risk

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

| | 2007 £m | 2006 £m |
|----------------------------------------------------------------------------------|----------------|----------------|
| Loans and advances to banks | 34,845 | 40,639 |
| Loans and advances to customers | 212,222 | 190,478 |
| Deposit amounts available for offset ¹ | (6,206) | (6,392) |
| Impairment losses | (2,408) | (2,194) |
| | 238,453 | 222,531 |
| Available-for-sale debt securities and treasury and other bills | 20,167 | 19,163 |
| Trading and other financial assets at fair value through profit or loss | 26,165 | 29,568 |
| Derivative assets, before netting | 8,659 | 5,565 |
| Amounts available for offset under master netting arrangements ¹ | (3,287) | (2,761) |
| | 5,372 | 2,804 |
| Assets arising from reinsurance contracts held | 350 | 451 |
| Financial guarantees | 9,753 | 8,139 |
| Irrevocable loan commitments and other credit-related contingencies ² | 56,600 | 54,065 |
| | 356,860 | 336,721 |
| Maximum credit risk exposure | 356,860 | 336,721 |
| Maximum credit risk exposure before offset items | 366,353 | 345,874 |

¹ Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

² See note 46 – Contingent liabilities and commitments for further information.

A general description of collateral held in respect of financial instruments is disclosed on page 42.

Loans and advances to banks – the Group may require collateral before entering into a credit commitment with another bank, depending on the type of the financial product and the counterparty involved, and netting agreements are obtained whenever possible and to the extent that such agreements are legally enforceable.

Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 15 and a similar analysis for available-for-sale financial assets is included in note 20. The Group's non-participating investment contracts are all unit-linked. Movements in the fair values of trading and other financial assets at fair value through profit or loss which back those investment contracts, including movements arising from credit risk, are borne by the contract holders.

47 Financial risk management continued

Derivative assets – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 16. Of the net derivative assets of £5,372 million (2006: £2,804 million), cash collateral of £2,004 million (2006: £912 million) was held and a further £1,459 million was due from OECD banks (2006: £1,251 million).

Assets arising from reinsurance contracts held – of the assets arising from reinsurance contracts held of £350 million (2006: £451 million), £341 million (2006: £447 million) are due from insurers with a credit rating of AA or above.

Financial guarantees – these represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

Reverse repo and repo transactions – for reverse repo transactions which are accounted for as collateralised loans, it is the Group's policy to seek collateral which is at least equal to the amount loaned. At 31 December 2007, the fair value of collateral accepted under reverse repo transactions that the Group is permitted by contract or custom to sell or repledge was £10,300 million (2006: £6,446 million). Of this, £10,299 million (2006: £6,445 million) was sold or repledged as at 31 December 2007, including £768 million (2006: £1,099 million) in respect of repo transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge. The remainder has been held for continuing use within the business.

Loans and advances

| | Loans and advances to customers | | | | Loans and advances designated at fair value through profit or loss £m | Loans and advances to banks £m |
|-------------------------------------------|---------------------------------|----------------------|-----------------|-------------|--------------------------------------------------------------------------|-----------------------------------|
| | Retail – mortgages £m | Retail – other £m | Wholesale £m | Total £m | | |
| 31 December 2007 | | | | | | |
| Neither past due nor impaired | 99,828 | 29,850 | 73,475 | 203,153 | 1,189 | 34,845 |
| Past due but not impaired | 2,153 | 966 | 639 | 3,758 | – | – |
| Impaired – no provision required | 415 | 100 | 293 | 808 | – | – |
| – provision held | 343 | 3,600 | 560 | 4,503 | – | – |
| Gross | 102,739 | 34,516 | 74,967 | 212,222 | 1,189 | 34,845 |
| Allowance for impairment losses (note 19) | (37) | (2,029) | (342) | (2,408) | – | – |
| Net | 102,702 | 32,487 | 74,625 | 209,814 | 1,189 | 34,845 |
| 31 December 2006 | | | | | | |
| Neither past due nor impaired | 92,873 | 29,364 | 60,005 | 182,242 | 835 | 40,638 |
| Past due but not impaired | 1,943 | 1,005 | 374 | 3,322 | – | – |
| Impaired – no provision required | 658 | 92 | 158 | 908 | – | – |
| – provision held | 127 | 3,580 | 299 | 4,006 | – | 1 |
| Gross | 95,601 | 34,041 | 60,836 | 190,478 | 835 | 40,639 |
| Allowance for impairment losses (note 19) | (42) | (1,918) | (233) | (2,193) | – | (1) |
| Net | 95,559 | 32,123 | 60,603 | 188,285 | 835 | 40,638 |

The analysis of lending between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

Loans and advances which are neither past due nor impaired

| | Loans and advances to customers | | | | Loans and advances designated at fair value through profit or loss £m | Loans and advances to banks £m |
|----------------------------------|---------------------------------|----------------------|-----------------|-------------|--------------------------------------------------------------------------|-----------------------------------|
| | Retail – mortgages £m | Retail – other £m | Wholesale £m | Total £m | | |
| 31 December 2007 | | | | | | |
| Good quality | 99,407 | 18,157 | 46,240 | | 191 | 34,647 |
| Satisfactory quality | 378 | 8,964 | 25,013 | | 670 | 190 |
| Lower quality | 1 | 665 | 2,034 | | 327 | 7 |
| Below standard, but not impaired | 42 | 2,064 | 188 | | 1 | 1 |
| Total | 99,828 | 29,850 | 73,475 | 203,153 | 1,189 | 34,845 |
| 31 December 2006 | | | | | | |
| Good quality | 92,472 | 16,940 | 35,659 | | 513 | 40,418 |
| Satisfactory quality | 359 | 9,667 | 21,797 | | 314 | 201 |
| Lower quality | – | 663 | 2,249 | | 3 | 17 |
| Below standard, but not impaired | 42 | 2,094 | 300 | | 5 | 2 |
| Total | 92,873 | 29,364 | 60,005 | 182,242 | 835 | 40,638 |

47 Financial risk management continued

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Good quality lending includes the lower assessed default probabilities and all loans with low expected losses in the event of default, with other categories reflecting progressively higher risks and lower expected recoveries.

Loans and advances which are past due but not impaired

| | Loans and advances to customers | | | | Loans and advances designated at fair value through profit or loss £m | Loans and advances to banks £m |
|-------------------------------|---------------------------------|----------------------|-----------------|--------------|--------------------------------------------------------------------------|-----------------------------------|
| | Retail – mortgages £m | Retail – other £m | Wholesale £m | Total £m | | |
| 31 December 2007 | | | | | | |
| 0-30 days | 1,123 | 781 | 266 | 2,170 | – | – |
| 30-60 days | 445 | 155 | 107 | 707 | – | – |
| 60-90 days | 260 | 29 | 129 | 418 | – | – |
| 90-180 days | 325 | 1 | 67 | 393 | – | – |
| Over 180 days | – | – | 70 | 70 | – | – |
| Total | 2,153 | 966 | 639 | 3,758 | – | – |
| Fair value of collateral held | 2,111 | n/a | n/a | n/a | | |
| 31 December 2006 | | | | | | |
| 0-30 days | 1,104 | 797 | 156 | 2,057 | – | – |
| 30-60 days | 341 | 182 | 60 | 583 | – | – |
| 60-90 days | 216 | 26 | 38 | 280 | – | – |
| 90-180 days | 280 | – | 70 | 350 | – | – |
| Over 180 days | 2 | – | 50 | 52 | – | – |
| Total | 1,943 | 1,005 | 374 | 3,322 | – | – |
| Fair value of collateral held | 1,907 | n/a | n/a | n/a | | |

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

Collateral held against retail mortgage lending is principally comprised of residential properties; their fair value has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in the Halifax House Price Index, after making allowance for indexation error and dilapidations. The resulting valuation has been limited to the principal amount of the outstanding advance in order to provide a clearer representation of the Group's credit exposure.

Lending decisions are based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values for non-mortgage lending are assessed more rigorously at the time of loan origination or when taking enforcement action and may fluctuate, as in the case of floating charges, according to the level of assets held by the customer. Whilst collateral is reviewed on a regular basis in accordance with business unit credit policy, this varies according to the type of lending and collateral involved. It is therefore not practicable to estimate and aggregate current fair values of collateral for non-mortgage lending.

Renegotiated loans and advances

Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2007 totalled £579 million (2006: £342 million).

Reposessed collateral

| | 2007 £m | 2006 £m |
|----------------------|------------|------------|
| Residential property | 73 | 55 |
| Other | 9 | 10 |
| Total | 82 | 65 |

The Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

47 Financial risk management continued

Debt securities, treasury and other bills – analysis by credit rating

| As at 31 December 2007 | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|------------------------------------------------------------------|---------------|--------------|--------------|--------------|----------------------------|-----------------|---------------|
| Debt securities held at fair value through profit or loss | | | | | | | |
| Trading assets: | | | | | | | |
| Government securities | 62 | – | – | – | – | – | 62 |
| Mortgage backed securities | – | 28 | 51 | 8 | – | – | 87 |
| Other asset backed securities | – | 15 | 61 | 38 | 3 | 5 | 122 |
| Corporate and other debt securities | 268 | 1,268 | 1,390 | 103 | 59 | 519 | 3,607 |
| Total held as trading assets | 330 | 1,311 | 1,502 | 149 | 62 | 524 | 3,878 |
| Other assets held at fair value through profit or loss: | | | | | | | |
| Government securities | 4,808 | 6 | 15 | 1 | – | 18 | 4,848 |
| Bank and building society certificates of deposit | 42 | 548 | 53 | – | – | 168 | 811 |
| Mortgage backed securities | 61 | – | – | – | – | 9 | 70 |
| Other asset backed securities | 1,367 | 214 | 153 | 71 | – | – | 1,805 |
| Corporate and other debt securities | 5,118 | 1,606 | 2,868 | 2,528 | 340 | 1,104 | 13,564 |
| Total held at fair value through profit or loss | 11,726 | 3,685 | 4,591 | 2,749 | 402 | 1,823 | 24,976 |
| Available-for-sale financial assets | | | | | | | |
| Debt securities: | | | | | | | |
| Government securities | 310 | – | – | – | – | 9 | 319 |
| Other public sector securities | – | – | – | – | – | 5 | 5 |
| Bank and building society certificates of deposit | – | 1,683 | 125 | – | 15 | 2 | 1,825 |
| Mortgage backed securities | 5,880 | 14 | 10 | – | – | 146 | 6,050 |
| Other asset backed securities | 3,895 | 37 | 27 | – | – | 112 | 4,071 |
| Corporate and other debt securities | 3,822 | 1,170 | 186 | – | – | 1,092 | 6,270 |
| Total debt securities | 13,907 | 2,904 | 348 | – | 15 | 1,366 | 18,540 |
| Treasury bills and other bills | 31 | 1,596 | – | – | – | – | 1,627 |
| Total held as available-for-sale assets | 13,938 | 4,500 | 348 | – | 15 | 1,366 | 20,167 |
| As at 31 December 2006 | | | | | | | |
| | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
| Debt securities held at fair value through profit or loss | | | | | | | |
| Trading assets: | | | | | | | |
| Government securities | 148 | – | – | – | – | 32 | 180 |
| Mortgage backed securities | 235 | 57 | 114 | 35 | 5 | 5 | 451 |
| Other asset backed securities | 114 | 75 | 172 | 176 | 13 | 45 | 595 |
| Corporate and other debt securities | 345 | 1,773 | 1,616 | 59 | 6 | 347 | 4,146 |
| Total held as trading assets | 842 | 1,905 | 1,902 | 270 | 24 | 429 | 5,372 |
| Other assets held at fair value through profit or loss: | | | | | | | |
| Government securities | 8,558 | 30 | 32 | 1 | – | 5 | 8,626 |
| Other public sector securities | 13 | – | 6 | – | – | 25 | 44 |
| Bank and building society certificates of deposit | 16 | 345 | 47 | – | – | 165 | 573 |
| Mortgage backed securities | 56 | – | – | – | – | 31 | 87 |
| Other asset backed securities | 321 | 5 | 61 | 30 | – | 444 | 861 |
| Corporate and other debt securities | 5,870 | 1,598 | 2,915 | 1,597 | 153 | 1,037 | 13,170 |
| Total held at fair value through profit or loss | 15,676 | 3,883 | 4,963 | 1,898 | 177 | 2,136 | 28,733 |

Notes to the group accounts

47 Financial risk management continued

| As at 31 December 2006 | AAA £m | AA £m | A £m | BBB £m | Rated BB or lower £m | Not rated £m | Total £m |
|---------------------------------------------------|---------------|--------------|--------------|-----------|----------------------------|-----------------|---------------|
| Available-for-sale financial assets | | | | | | | |
| Debt securities: | | | | | | | |
| Government securities | 379 | – | – | – | – | 14 | 393 |
| Other public sector securities | 189 | – | – | – | – | – | 189 |
| Bank and building society certificates of deposit | 6 | 1,229 | 356 | 24 | – | – | 1,615 |
| Mortgage backed securities | 5,559 | 13 | – | – | – | 90 | 5,662 |
| Other asset backed securities | 4,598 | 80 | 27 | 6 | 5 | 5 | 4,721 |
| Corporate and other debt securities | 1,971 | 976 | 698 | – | – | 1,172 | 4,817 |
| Total debt securities | 12,702 | 2,298 | 1,081 | 30 | 5 | 1,281 | 17,397 |
| Treasury bills and other bills | 46 | 1,705 | – | – | 15 | – | 1,766 |
| Total held as available-for-sale assets | 12,748 | 4,003 | 1,081 | 30 | 20 | 1,281 | 19,163 |

There are no material amounts for debt securities, treasury and other bills which are past due but not impaired.

Liquidity risk

The table below analyses financial instrument liabilities of the Group, excluding those arising from insurance and participating investment 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; balances with no fixed maturity are included in the over 5 years category.

| | Up to 1 month £m | 1-3 months £m | 3-12 months £m | 1-5 years £m | Over 5 years £m | Total £m |
|------------------------------------------------------------------------------------------------------|------------------------|---------------------|----------------------|--------------------|-----------------------|----------------|
| As at 31 December 2007 | | | | | | |
| Deposits from banks | 35,466 | 2,218 | 1,480 | 26 | – | 39,190 |
| Customer accounts | 144,213 | 4,800 | 7,578 | 2,002 | 447 | 159,040 |
| Derivative financial instruments, trading and other liabilities at fair value through profit or loss | 10,286 | 2,176 | 3,607 | 1,589 | 1,851 | 19,509 |
| Debt securities in issue | 20,307 | 6,047 | 9,529 | 13,202 | 6,197 | 55,282 |
| Liabilities arising from non-participating investment contracts | 18,197 | – | – | – | – | 18,197 |
| Subordinated liabilities | 27 | 210 | 1,067 | 6,371 | 14,292 | 21,967 |
| Total | 228,496 | 15,451 | 23,261 | 23,190 | 22,787 | 313,185 |
| As at 31 December 2006 | | | | | | |
| Deposits from banks | 28,376 | 3,707 | 1,722 | 818 | 1,942 | 36,565 |
| Customer accounts | 129,381 | 3,492 | 5,560 | 2,355 | 411 | 141,199 |
| Derivative financial instruments, trading and other liabilities at fair value through profit or loss | 8,928 | 2,037 | 2,600 | 663 | 887 | 15,115 |
| Debt securities in issue | 28,887 | 5,231 | 6,569 | 11,030 | 7,176 | 58,893 |
| Liabilities arising from non-participating investment contracts | 24,370 | – | – | – | – | 24,370 |
| Subordinated liabilities | 14 | 186 | 922 | 4,323 | 13,619 | 19,064 |
| Total | 219,956 | 14,653 | 17,373 | 19,189 | 24,035 | 295,206 |

Derivatives (other than those used in a hedging relationship) and trading liabilities are included in the up to 1 month column at their fair value. Liquidity risk on these items is not managed on the basis of contractual maturity as they are frequently settled on demand at fair value and therefore this is considered a better presentation of the Group's liquidity risk. Derivatives used in a hedging relationship are included according to their contractual maturity.

Cash flows for undated subordinated liabilities whose terms give the Group the option to redeem at a future date are included within the table on the basis that the Group will exercise its option to redeem.

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £223 million per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

47 Financial risk management continued

Liabilities arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

| | Up to 1 month £m | 1-3 months £m | 3-12 months £m | 1-5 years £m | Over 5 years £m | Total £m |
|-------------------------------|------------------------|---------------------|----------------------|--------------------|-----------------------|---------------|
| As at 31 December 2007 | 238 | 651 | 1,570 | 9,548 | 26,056 | 38,063 |
| As at 31 December 2006 | 247 | 716 | 1,852 | 9,682 | 28,948 | 41,445 |

The following tables set out the amounts and residual maturities of Lloyds TSB Group's off balance sheet contingent liabilities and commitments.

| 31 December 2007 | Within 1 year £m | 1-3 years £m | 3-5 years £m | Over 5 years £m | Total £m |
|------------------------------------------|------------------------|--------------------|--------------------|-----------------------|---------------|
| Acceptances | 39 | 1 | – | – | 40 |
| Other contingent liabilities | 1,441 | 1,032 | 255 | 796 | 3,524 |
| Total contingent liabilities | 1,480 | 1,033 | 255 | 796 | 3,564 |
| Lending commitments | 60,981 | 13,759 | 10,634 | 4,221 | 89,595 |
| Other commitments | 466 | 78 | 108 | 117 | 769 |
| Total commitments | 61,447 | 13,837 | 10,742 | 4,338 | 90,364 |
| Total contingents and commitments | 62,927 | 14,870 | 10,997 | 5,134 | 93,928 |

| 31 December 2006 | Within 1 year £m | 1-3 years £m | 3-5 years £m | Over 5 years £m | Total £m |
|------------------------------------------|------------------------|--------------------|--------------------|-----------------------|---------------|
| Acceptances | 62 | 1 | – | – | 63 |
| Other contingent liabilities | 953 | 976 | 263 | 522 | 2,714 |
| Total contingent liabilities | 1,015 | 977 | 263 | 522 | 2,777 |
| Lending commitments | 56,019 | 11,310 | 11,050 | 3,900 | 82,279 |
| Other commitments | 5,945 | 109 | 23 | 61 | 6,138 |
| Total commitments | 61,964 | 11,419 | 11,073 | 3,961 | 88,417 |
| Total contingents and commitments | 62,979 | 12,396 | 11,336 | 4,483 | 91,194 |

Fair values of financial assets and liabilities

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been estimated using market prices for instruments held by the Group. Where market prices are not available, fair values have been estimated using quoted values for instruments with characteristics either identical or similar to those of the instruments held by the Group. These estimation techniques are necessarily subjective in nature and involve several assumptions.

The fair values presented in the following table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group's financial position.

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

The valuation technique for each major category of financial instrument is discussed below.

Trading and other financial assets at fair value through profit or loss

The fair values of financial instruments quoted in active markets are based on quoted prices. The fair values of financial instruments that are not quoted in active markets are determined using valuation techniques including cash flow models which, to the extent practical, use observable market inputs such as interest rate yield curves, equities and commodities prices, option volatilities and currency rates that are either directly observable or are implied from instrument prices.

Derivative financial instruments

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative.

47 Financial risk management continued

Loans and advances to banks and customers

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period.

Available-for-sale financial assets

Listed securities are valued at current bid prices. Unlisted securities and other financial assets are valued based on discounted cash flows, market prices of similar instruments and other appropriate valuation techniques.

Deposits from banks and customer accounts

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits and customer accounts is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Debt securities in issue and subordinated liabilities

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

Trading and other liabilities at fair value through profit or loss

The fair values of financial instruments quoted in active markets are based on quoted prices. The fair values of financial instruments that are not quoted in active markets are determined using valuation techniques including cash flow models which, to the extent practical, use observable market inputs such as interest rate yield curves, equities and commodities prices, option volatilities and currency rates that are either directly observable or are implied from instrument prices.

Liabilities arising from non-participating investment contracts

The value of the Group's non-participating investment contracts, all of which are unit-linked, is contractually linked to the fair values of financial assets within the Group's unitised investment funds and is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable.

Financial commitments and contingent liabilities

Financial guarantees are valued on the basis of cash premiums receivable. The Group considers that it is not meaningful or practical to provide an estimate of the fair value of other contingent liabilities and financial commitments, given the lack of an established market, the diversity of fee structures and the difficulty of separating the value of the instruments from the value of the overall transaction. Therefore only financial guarantees are included in the following table.

| | Carrying value 2007 £m | Carrying value 2006 £m | Fair value 2007 £m | Fair value 2006 £m |
|-------------------------------------------------------------------------|------------------------------|------------------------------|--------------------------|--------------------------|
| Financial assets | | | | |
| Trading and other financial assets at fair value through profit or loss | 57,911 | 67,695 | 57,911 | 67,695 |
| Derivative financial instruments | 8,659 | 5,565 | 8,659 | 5,565 |
| Loans and advances to banks | 34,845 | 40,638 | 34,832 | 40,641 |
| Loans and advances to customers | 209,814 | 188,285 | 209,066 | 187,977 |
| Available-for-sale financial assets | 20,196 | 19,178 | 20,196 | 19,178 |
| Financial liabilities | | | | |
| Deposits from banks | 39,091 | 36,394 | 39,063 | 36,383 |
| Customer accounts | 156,555 | 139,342 | 156,608 | 139,263 |
| Trading and other liabilities at fair value through profit or loss | 3,206 | 1,184 | 3,206 | 1,184 |
| Derivative financial instruments | 7,582 | 5,763 | 7,582 | 5,763 |
| Debt securities in issue | 51,572 | 54,118 | 51,312 | 54,070 |
| Liabilities arising from non-participating investment contracts | 18,197 | 24,370 | 18,197 | 24,370 |
| Financial guarantees | 26 | 49 | 26 | 49 |
| Subordinated liabilities | 11,958 | 12,072 | 12,128 | 12,767 |

48 Acquisitions

During 2006, the Group, through its Asset Finance subsidiaries, acquired two businesses engaged in consumer finance for a total consideration of £16 million, settled in cash in that year. Goodwill of £4 million arose on those acquisitions; no significant fair value adjustments were made.

49 Consolidated cash flow statement

(a) Change in operating assets

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------------------------------------------------------------|-----------------|-----------------|
| Change in loans and advances to banks | 8,673 | (11,063) |
| Change in loans and advances to customers | (20,796) | (13,910) |
| Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss | (4,348) | (7,072) |
| Change in other operating assets | (511) | 50 |
| Change in operating assets | (16,982) | (31,995) |

(b) Change in operating liabilities

| | 2007 £m | 2006 £m |
|----------------------------------------------------------------------------------------------------------------|---------------|---------------|
| Change in deposits from banks | 2,136 | 5,222 |
| Change in customer accounts | 17,172 | 8,523 |
| Change in debt securities in issue | (2,450) | 15,068 |
| Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss | 3,840 | 556 |
| Change in investment contract liabilities | (58) | 3,795 |
| Change in other operating liabilities | 901 | (95) |
| Change in operating liabilities | 21,541 | 33,069 |

(c) Non-cash and other items

| | 2007 £m | 2006 £m |
|--------------------------------------------------|--------------|--------------|
| Depreciation and amortisation | 630 | 619 |
| Revaluation of investment property | 321 | (631) |
| Allowance for loan losses | 1,721 | 1,560 |
| Write-off of allowance for loan losses | (1,405) | (1,299) |
| Impairment of available-for-sale securities | 70 | - |
| Insurance claims | 7,522 | 8,569 |
| Insurance claims paid | (6,669) | (7,509) |
| Customer remediation paid | (54) | (93) |
| Other provision movements | 2 | (19) |
| Net charge in respect of defined benefit schemes | 175 | 109 |
| Contributions to defined benefit schemes | (452) | (556) |
| Other non-cash items | 870 | 104 |
| Total non-cash items | 2,731 | 854 |
| Interest expense on subordinated liabilities | 756 | 744 |
| Profit on disposal of businesses | (657) | - |
| Other | (46) | (43) |
| Total other items | 53 | 701 |
| Non-cash and other items | 2,784 | 1,555 |

Notes to the group accounts

49 Consolidated cash flow statement continued

(d) Analysis of cash and cash equivalents as shown in the balance sheet

| | 2007 £m | 2006 £m |
|-------------------------------------------------------|------------|------------|
| Cash and balances with central banks | 4,330 | 1,898 |
| Less: mandatory reserve deposits ¹ | (338) | (300) |
| | 3,992 | 1,598 |
| Loans and advances to banks | 34,845 | 40,638 |
| Less: amounts with a maturity of three months or more | (6,946) | (16,798) |
| | 27,899 | 23,840 |
| Total cash and cash equivalents | 31,891 | 25,438 |

¹ Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

Included within cash and cash equivalents at 31 December 2007 is £7,426 million (2006: £9,054 million) held within the Group's life funds, which is not immediately available for use in the business.

(e) Analysis of changes in financing during the year

| | 2007 £m | 2006 £m |
|--------------------------------------------------|------------|------------|
| Share capital (including share premium account): | | |
| At 1 January | 2,695 | 2,590 |
| Issue of share capital | 35 | 105 |
| At 31 December | 2,730 | 2,695 |
| | 2007 £m | 2006 £m |
| Minority interests: | | |
| At 1 January | 352 | 435 |
| Exchange and other adjustments | (1) | (4) |
| Repayment of capital to minority shareholders | (80) | (151) |
| Minority share of profit after tax | 32 | 104 |
| Dividends to minority shareholders | (19) | (32) |
| At 31 December | 284 | 352 |
| | 2007 £m | 2006 £m |
| Subordinated liabilities: | | |
| At 1 January | 12,072 | 12,402 |
| Exchange and other adjustments | 186 | (687) |
| Issue of subordinated liabilities | - | 1,116 |
| Repayments of subordinated liabilities | (300) | (759) |
| At 31 December | 11,958 | 12,072 |

49 Consolidated cash flow statement continued**(f) Acquisition of group undertakings and businesses**

| | 2007 £m | 2006 £m |
|----------------------------------------------------------------------------------------------------|------------|------------|
| Net assets acquired: | | |
| Loans and advances to customers | - | 11 |
| Other assets | - | 1 |
| | - | 12 |
| Goodwill arising on consolidation | - | 4 |
| Net cash outflow from acquisitions in the year | - | 16 |
| Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000 | 8 | 4 |
| Net cash outflow from acquisitions | 8 | 20 |

(g) Disposal and closure of group undertakings and businesses

| | 2007 £m | 2006 £m |
|-------------------------------------------------------------------------------------|------------|------------|
| Cash and balances at central banks | 37 | - |
| Trading and other financial assets at fair value through profit or loss | 10,999 | - |
| Loans and advances to banks | 1,150 | - |
| Value of in-force business | 412 | - |
| Liabilities arising from insurance contracts and participating investment contracts | (4,349) | - |
| Liabilities arising from non-participating investment contracts | (7,283) | - |
| Unallocated surplus within insurance businesses | (15) | - |
| Other net assets and liabilities | (95) | - |
| | 856 | - |
| Profit on sale of businesses | 657 | - |
| Cash and cash equivalents disposed of | (37) | - |
| Consideration for 2005 disposal settled in cash | - | 936 |
| Net cash inflow from disposals | 1,476 | 936 |

50 Future developments

The following pronouncements will be relevant to the Group but were not effective at 31 December 2007 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group, however, the initial view is that none of these pronouncements are expected to cause any material adjustments to reported numbers in the financial statements.

| Pronouncement | Nature of change | Effective date |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------|
| IFRIC 11 IFRS 2 – Group and Treasury Share Transactions | Clarifies the application of IFRS 2 Share-based Payment to certain share-based payment arrangements involving own equity instruments and arrangements involving equity instruments of a parent entity. | Annual periods beginning on or after 1 March 2007. |
| IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirement and their Interaction ¹ | Provides guidance on the availability of refunds or reductions in future contributions for retirement plans and specifies how a minimum funding requirement might either affect the availability of reductions in future contributions or give rise to a liability. | Annual periods beginning on or after 1 January 2008. |
| IFRIC 13 Customer Loyalty Programmes ^{1,2} | Addresses accounting by entities who grant customer loyalty award credits to customers as part of sales transactions and which can be redeemed in the future for free or discounted goods or services. | Annual periods beginning on or after 1 July 2008. |
| IAS 1 Presentation of Financial Statements ^{1,2} | Revises the overall requirements for the presentation of financial statements, guidance for their structure and minimum content requirements. The revised standard requires the presentation of all non-owner changes in equity within a statement of comprehensive income. | Annual periods beginning on or after 1 January 2009. |
| IAS 23 Borrowing Costs ^{1,2} | Requires interest and other costs incurred in connection with the borrowing of funds to be recognised as an expense excepting that those which are directly attributable to the acquisition, construction or production of assets that take a substantial period of time to get ready for their intended use or sale must be capitalised as part of the cost of those assets. | Annual periods beginning on or after 1 January 2009. |
| IFRS 8 Operating Segments ² | Replaces IAS 14 Segment Reporting and requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. | Annual periods beginning on or after 1 January 2009. |
| IFRS 2 Share-based Payment – Vesting Conditions and Cancellations ^{1,2} | The amendment restricts the definition of vesting conditions to include only service conditions and performance conditions and deals with the accounting consequences of a failure to meet a condition other than a vesting condition including how to deal with cancellations by the counterparty and circumstances where neither the entity nor the counterparty is in a position to choose whether or not to meet a vesting condition. | Annual periods beginning on or after 1 January 2009. |
| Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation ^{1,2} | The amendment requires some puttable financial instruments (being those which give the holder the right to put the instrument back to the issuer for cash or another financial asset) and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity. | Annual periods beginning on or after 1 January 2009. |
| IFRS 3 Business Combinations ^{1,2} | The revised standard continues to apply the acquisition method to business combinations, however, all payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the minority interest, and all transaction costs are expensed. | Annual periods beginning on or after 1 July 2009. |

50 Future developments continued

| | | |
|----------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------|
| IAS 27 Consolidated and Separate Financial Statements ^{1,2} | Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is re-measured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost. | Annual periods beginning on or after 1 July 2009. |
|----------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------|

¹ At the date of this report, these pronouncements are awaiting EU endorsement.

² Subject to any EU endorsement, the Group has not yet made a final decision as to whether it will apply these pronouncements in the 2008 financial statements.

51 Approval of financial statements

The consolidated financial statements were approved by the directors of Lloyds TSB Group plc on 21 February 2008.

Report of the independent auditors on the parent company financial statements

To the members of Lloyds TSB Group plc

We have audited the parent company financial statements of Lloyds TSB Group plc for the year ended 31 December 2007 which comprise the balance sheet, the statement of changes in equity, the cash flow statement and the related notes. These parent company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the directors' remuneration report on pages 64 to 75 that is described as having been audited.

We have reported separately on the consolidated financial statements of Lloyds TSB Group plc for the year ended 31 December 2007.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report, the directors' remuneration report and the parent company financial statements in accordance with applicable law and International Financial Reporting Standards ('IFRSs') as adopted by the European Union are set out in the statement of directors' responsibilities on page 63.

Our responsibility is to audit the parent company financial statements and the part of the directors' remuneration report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the parent company financial statements give a true and fair view and whether the parent company financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you whether, in our opinion, the information given in the directors' report is consistent with the parent company financial statements. The information given in the directors' report includes that specific information presented in the Overview and the Business Review that is cross referred from the principal activities, business review, future developments and financial risk management objectives and policies section of the directors' report.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the annual report and consider whether it is consistent with the audited parent company financial statements. The other information comprises only the chairman's statement, the group chief executive's review, the Business Review, the directors' report, the corporate governance disclosures, the unaudited part of the directors' remuneration report and the shareholder information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent company financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the parent company financial statements and the part of the directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the parent company financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the parent company financial statements and the part of the directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the parent company financial statements and the part of the directors' remuneration report to be audited.

Opinion

In our opinion:

- the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2007 and cash flows for the year then ended;
- the parent company financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the directors' report is consistent with the parent company financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Southampton, England
21 February 2008

Parent company balance sheet

at 31 December 2007

| | Note | 2007 £ million | 2006 £ million |
|-------------------------------------|------|-------------------|-------------------|
| Assets | | | |
| Non-current assets: | | | |
| Investment in subsidiaries | 8 | 5,589 | 5,589 |
| Loans to subsidiaries | 8 | 2,820 | 1,723 |
| Deferred tax assets | 2 | 2 | – |
| | | 8,411 | 7,312 |
| Current assets: | | | |
| Derivative financial instruments | | 169 | 114 |
| Other assets | | 165 | 146 |
| Amounts due from subsidiaries | 3 | 92 | 203 |
| Cash and cash equivalents | | 58 | 1,213 |
| | | 484 | 1,676 |
| Total assets | | 8,895 | 8,988 |
| Equity and liabilities | | | |
| Capital and reserves: | | | |
| Share capital | 4 | 1,432 | 1,429 |
| Share premium account | 4 | 1,298 | 1,266 |
| Retained profits | 5 | 1,935 | 2,026 |
| Total equity | | 4,665 | 4,721 |
| Non-current liabilities: | | | |
| Subordinated liabilities | 6 | 2,345 | 2,297 |
| Debt securities in issue | 7 | 50 | – |
| | | 2,395 | 2,297 |
| Current liabilities: | | | |
| Debt securities in issue | 7 | 1,694 | – |
| Current tax liabilities | | 28 | 43 |
| Derivative financial instruments | | 29 | – |
| Amounts owed to subsidiaries | | – | 1,850 |
| Other liabilities | | 84 | 77 |
| | | 1,835 | 1,970 |
| Total liabilities | | 4,230 | 4,267 |
| Total equity and liabilities | | 8,895 | 8,988 |

The accompanying notes are an integral part of the parent company financial statements.

The directors approved the parent company financial statements on 21 February 2008.

Sir Victor Blank
Chairman

J Eric Daniels
Group Chief Executive

Helen A Weir
Group Finance Director

Parent company statement of changes in equity

| | Share capital and premium £ million | Retained profits £ million | Total £ million |
|------------------------------------|-------------------------------------------|----------------------------------|--------------------|
| Balance at 1 January 2006 | 2,590 | 2,055 | 4,645 |
| Profit for the year* | – | 1,877 | 1,877 |
| Dividends | – | (1,919) | (1,919) |
| Purchase/sale of treasury shares | – | (20) | (20) |
| Employee share option schemes: | | | |
| Value of employee services | – | 33 | 33 |
| Proceeds from shares issued | 105 | – | 105 |
| Balance at 31 December 2006 | 2,695 | 2,026 | 4,721 |
| Profit for the year* | – | 1,855 | 1,855 |
| Dividends | – | (1,957) | (1,957) |
| Purchase/sale of treasury shares | – | (19) | (19) |
| Employee share option schemes: | | | |
| Value of employee services | – | 30 | 30 |
| Proceeds from shares issued | 35 | – | 35 |
| Balance at 31 December 2007 | 2,730 | 1,935 | 4,665 |

* No income statement has been shown for the parent company, as permitted by section 230 of the Companies Act 1985.

Parent company cash flow statement

for the year ended 31 December 2007

| | 2007 £ million | 2006 £ million |
|------------------------------------------------------------|-------------------|-------------------|
| Profit before tax | 1,870 | 1,893 |
| Dividend income | (1,957) | (1,918) |
| Fair value and exchange adjustments | 10 | 3 |
| Change in other assets | 103 | (44) |
| Change in other liabilities | (128) | 156 |
| Tax (paid) received | (32) | 46 |
| Net cash (used in) provided by operating activities | (134) | 136 |
| Cash flows from investing activities | | |
| Capital lending to subsidiaries | (1,111) | – |
| Cash flows from financing activities | | |
| Dividends received from subsidiaries | 1,957 | 1,918 |
| Dividends paid to equity shareholders | (1,957) | (1,919) |
| Proceeds from issue of debt securities | 1,770 | – |
| Proceeds from issue of subordinated liabilities | – | 1,116 |
| Proceeds from issue of ordinary shares | 35 | 105 |
| Repayment of subordinated liabilities | – | (250) |
| Repayment of amounts due to subsidiaries | (1,715) | – |
| Net cash generated by financing activities | 90 | 970 |
| Change in cash and cash equivalents | (1,155) | 1,106 |
| Cash and cash equivalents at beginning of year | 1,213 | 107 |
| Cash and cash equivalents at end of year | 58 | 1,213 |

The accompanying notes are an integral part of the parent company financial statements.

Notes to the parent company accounts

1 Accounting policies

The parent company has applied International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) in its financial statements for the year ended 31 December 2007. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 'Financial Instruments: Recognition and Measurement' relaxes some of the hedge accounting requirements; the Company has not taken advantage of this relaxation, and therefore there is no difference in application to the Company between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of all derivative contracts.

The accounting policies of the parent company are the same as those of the Group which are set out in note 1 to the consolidated financial statements, except that it has no policy in respect of consolidation and investments in subsidiaries are carried at historical cost, less any provisions for impairment.

2 Deferred tax assets

The movement in the net deferred tax asset is as follows:

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------|------------|------------|
| At 1 January | – | 21 |
| Income statement credit (charge) | 2 | (8) |
| Amount debited to equity in respect of employee share schemes | – | (13) |
| At 31 December | 2 | – |

The deferred tax assets relate to temporary differences.

3 Amounts due from subsidiaries

These comprise short-term lending to subsidiaries, repayable on demand. The fair values of amounts owed by subsidiaries are equal to their carrying amounts. No provisions have been recognised in respect of amounts owed by subsidiaries.

4 Share capital and share premium

Details of the Company's share capital and share premium account are as set out in notes 39 and 40 to the consolidated financial statements.

5 Retained profits

| | £m |
|-----------------------------------------------------------|---------|
| At 1 January 2006 | 2,055 |
| Profit for the year | 1,877 |
| Dividends | (1,919) |
| Purchase/sale of treasury shares | (20) |
| Employee share option schemes: value of employee services | 33 |
| At 31 December 2006 | 2,026 |
| Profit for the year | 1,855 |
| Dividends | (1,957) |
| Purchase/sale of treasury shares | (19) |
| Employee share option schemes: value of employee services | 30 |
| At 31 December 2007 | 1,935 |

Details of the Company's dividends are as set out in note 43 to the consolidated financial statements.

6 Subordinated liabilities

| | 2007 £m | 2006 £m |
|---------------------------------------------------------------------------------------------------------------|--------------|--------------|
| Preferred securities | | |
| Fixed/Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million) [†] | 593 | 587 |
| Fixed/Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$ 1,000 million) [†] | 515 | 504 |
| 6% Non-cumulative Redeemable Preference Shares | - | - |
| Undated subordinated liabilities | | |
| 6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)* | 497 | 497 |
| Dated subordinated liabilities | | |
| 9½% Subordinated Bonds 2011 (£150 million) | 149 | 149 |
| 5¾% Subordinated Guaranteed Bonds 2014 (€750 million) | 591 | 560 |
| | 740 | 709 |
| Total subordinated liabilities | 2,345 | 2,297 |

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer.

* In certain circumstances, these bonds would acquire the characteristics of preference share capital. Any repayments of undated loan capital would require the prior consent of the Financial Services Authority. They are accounted for as liabilities as coupon payments are mandatory as a consequence of the terms of certain preference shares. At the callable date the coupon on these bonds will be reset by reference to the applicable five year benchmark gilt rate.

[†] Further information regarding the fixed/floating rate non-cumulative callable preference shares can be found in note 39 to the consolidated financial statements.

7 Debt securities in issue

These comprise the US\$1,400 million Thirteen-Month Extendible Short-Term Notes and the US\$1,725 million Thirteen-Month Extendible Short-Term Notes issued by the Company in May 2007.

8 Related party transactions

Key management personnel

The key management personnel of the Group and parent company are the same. The relevant disclosures are given in note 45 to the consolidated financial statements.

The Company has no employees (2006: nil).

As discussed in note 44 to the consolidated financial statements, the Group provides share based compensation to employees through a number of schemes; these are all in relation to shares in the Company and the cost of providing those benefits is recharged to the employing companies in the Group on a cash basis.

Investment in subsidiaries

The Company's investment in subsidiaries is carried at cost: there has been no movement in the carrying value during the year and there has been no impairment of the Company's investment in subsidiaries.

Notes to the parent company accounts

8 Related party transactions continued

The principal subsidiaries, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of Lloyds TSB Group plc, are:

| | Country of registration/ Incorporation | Percentage of equity share capital and voting rights held | Nature of business |
|------------------------------------------------------|-------------------------------------------|-----------------------------------------------------------|-----------------------------------------------|
| Lloyds TSB Bank plc | England | 100% | Banking and financial services |
| Lloyds TSB Commercial Finance Limited | England | 100%† | Credit factoring |
| Lloyds TSB Leasing Limited | England | 100%† | Financial leasing |
| Lloyds TSB Private Banking Limited | England | 100%† | Private banking |
| The Agricultural Mortgage Corporation PLC | England | 100%† | Long-term agricultural finance |
| Lloyds TSB Offshore Limited | Jersey | 100%† | Banking and financial services |
| Lloyds TSB Scotland plc | Scotland | 100%† | Banking and financial services |
| Lloyds TSB General Insurance Limited | England | 100%† | General insurance |
| Scottish Widows Investment Partnership Group Limited | England | 100%† | Investment management |
| Lloyds TSB Insurance Services Limited | England | 100%† | Insurance broking |
| Lloyds TSB Asset Finance Division Limited | England | 100%† | Consumer credit, leasing and related services |
| Black Horse Limited | England | 100%† | Consumer credit, leasing and related services |
| Scottish Widows plc | Scotland | 100%† | Life assurance |
| Scottish Widows Annuities Limited | Scotland | 100%† | Life assurance |

† Indirect interest.

The principal area of operation for each of the above subsidiaries is the United Kingdom and the Channel Islands, except as follows:

Lloyds TSB Bank plc operates principally in the UK but also through branches in Belgium, Dubai, Ecuador, France, Gibraltar, Hong Kong, Japan, Luxembourg, Malaysia, Monaco, Netherlands, Singapore, Spain, Switzerland, Uruguay and the USA, and a representative office in China.

None of the parent company's subsidiaries has experienced any significant restrictions in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

| Loans to subsidiaries: | 2007 £m | 2006 £m |
|--------------------------------|------------|------------|
| At 1 January | 1,723 | 1,723 |
| Exchange and other adjustments | (14) | – |
| Amounts advanced | 1,111 | – |
| At 31 December | 2,820 | 1,723 |

In addition the parent company carried out all of its banking activities through its subsidiary, Lloyds TSB Bank plc (the 'Bank'). At 31 December 2007, the parent company held deposits of £58 million with the Bank (2006: £1,213 million). Given the volume of transactions flowing through the account, it is not meaningful to provide gross inflow and outflow information. In addition, at 31 December 2007 the parent company had interest rate and currency swaps with the Bank with an aggregate notional principal amount of £4,032 million and a net positive fair value of £140 million (2006: notional principal amount of £2,228 million and a positive fair value of £114 million), designated as fair value hedges to manage the Company's issuance of subordinated liabilities and debt securities in issue.

Related party information in respect of other related party transactions is given in note 45 to the consolidated financial statements.

9 Financial instruments

Measurement basis of financial assets and liabilities

The accounting policies in note 1 to the consolidated financial statements describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

| | Derivatives designated as hedging instruments, held at fair value through profit or loss £m | Loans and receivables £m | Held at amortised cost £m | Total £m |
|------------------------------------|---------------------------------------------------------------------------------------------------------|--------------------------------|------------------------------------|--------------|
| As at 31 December 2007 | | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | – | – | 58 | 58 |
| Derivative financial instruments | 169 | – | – | 169 |
| Loans to subsidiaries | – | 2,820 | – | 2,820 |
| Amounts due from subsidiaries | – | 92 | – | 92 |
| Total financial assets | 169 | 2,912 | 58 | 3,139 |
| Financial liabilities: | | | | |
| Derivative financial instruments | 29 | – | – | 29 |
| Debt securities in issue | – | – | 1,744 | 1,744 |
| Subordinated liabilities | – | – | 2,345 | 2,345 |
| Total financial liabilities | 29 | – | 4,089 | 4,118 |

| | Derivatives designated as hedging instruments, held at fair value through profit or loss £m | Loans and receivables £m | Held at amortised cost £m | Total £m |
|------------------------------------|---------------------------------------------------------------------------------------------------------|--------------------------------|------------------------------------|--------------|
| As at 31 December 2006 | | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | – | – | 1,213 | 1,213 |
| Derivative financial instruments | 114 | – | – | 114 |
| Loans to subsidiaries | – | 1,723 | – | 1,723 |
| Amounts due from subsidiaries | – | 203 | – | 203 |
| Total financial assets | 114 | 1,926 | 1,213 | 3,253 |
| Financial liabilities: | | | | |
| Amounts owed to subsidiaries | – | – | 1,850 | 1,850 |
| Subordinated liabilities | – | – | 2,297 | 2,297 |
| Total financial liabilities | – | – | 4,147 | 4,147 |

Interest rate risk and currency risk

The Company is exposed to interest rate risk and currency risk on its debt securities in issue and its subordinated debt.

As discussed in note 8, the Company has entered into interest rate and currency swaps with its subsidiary, Lloyds TSB Bank plc, to manage these risks.

Credit risk

The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary, Lloyds TSB Bank plc, and subsidiaries of that company. The credit ratings of Lloyds TSB Bank plc are disclosed on page 50.

Notes to the parent company accounts

9 Financial instruments continued

Liquidity risk

The table below analyses financial instrument liabilities of the Company, 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, balances with no fixed maturity are included in the over 5 years category.

| | Up to 1 month £m | 1-3 months £m | 3-12 months £m | 1-5 years £m | Over 5 years £m | Total £m |
|----------------------------------|------------------------|---------------------|----------------------|--------------------|-----------------------|--------------|
| As at 31 December 2007 | | | | | | |
| Derivative financial instruments | 10 | 20 | 1,791 | – | – | 1,821 |
| Debt securities in issue | 8 | 15 | 1,740 | 50 | – | 1,813 |
| Subordinated liabilities | 11 | 21 | 97 | 516 | 3,195 | 3,840 |
| Total | 29 | 56 | 3,628 | 566 | 3,195 | 7,474 |
| As at 31 December 2006 | | | | | | |
| Amounts owed to subsidiaries | 1,850 | – | – | – | – | 1,850 |
| Subordinated liabilities | 11 | 21 | 96 | 512 | 3,271 | 3,911 |
| Total | 1,861 | 21 | 96 | 512 | 3,271 | 5,761 |

Fair values of financial assets and liabilities

The valuation techniques for the Company's financial instruments are as discussed in note 47 to the consolidated financial statements.

| | Carrying value 2007 £m | Carrying value 2006 £m | Fair value 2007 £m | Fair value 2006 £m |
|----------------------------------|---------------------------------|---------------------------------|-----------------------------|-----------------------------|
| Financial assets: | | | | |
| Cash and cash equivalents | 58 | 1,213 | 58 | 1,213 |
| Derivative financial instruments | 169 | 114 | 169 | 114 |
| Loans to subsidiaries | 2,820 | 1,723 | 2,856 | 1,825 |
| Amounts due from subsidiaries | 92 | 203 | 92 | 203 |
| Financial liabilities: | | | | |
| Amounts owed to subsidiaries | – | 1,850 | – | 1,850 |
| Derivative financial instruments | 29 | – | 29 | – |
| Debt securities in issue | 1,744 | – | 1,744 | – |
| Subordinated liabilities | 2,345 | 2,297 | 2,134 | 2,217 |

10 Approval of the financial statements and other information

The parent company financial statements were approved by the directors of Lloyds TSB Group plc on 21 February 2008.

Lloyds TSB Group plc was incorporated as a public limited company and registered in Scotland under the UK Companies Act 1985 on 21 October 1985 with the registered number 95000. Lloyds TSB Group plc's registered office is Henry Duncan House, 120 George Street, Edinburgh EH2 4LH, Scotland, and its principal executive offices in the UK are located at 25 Gresham Street, London EC2V 7HN.

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