Lloyds Banking Group plc
Form 20-F
May 13, 2010

As filed with the Securities and Exchange Commission on 13 May 2010

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

FORM 20-F

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

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended 31 December 2009

OR

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

OR

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

Commission file number 001-15246

LLOYDS BANKING GROUP plc

(previously Lloyds TSB Group plc)
(Exact name of Registrant as Specified in Its Charter)

Scotland
(Jurisdiction of Incorporation or Organization)

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

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

Title of each class	**Name of each exchange on which registered**
Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares.	The New York Stock Exchange.

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

None

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

None

The number of outstanding shares of each of Lloyds Banking Group plc s classes of capital or common stock as of 31 December 2009 was:

Ordinary shares, nominal value 10 pence each	63,774,511,536
Limited voting shares, nominal value 10 pence each	80,921,051
Deferred shares, nominal value 15 pence each	27,242,603,417
Preference shares, nominal value 25 pence each	484,144,705
Preference shares, nominal value 25 cents each	3,038,001
Preference shares, nominal value 25 euro cents each	500,000

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

Yes x No o

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

Yes o No x

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

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

Yes x No o

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

Yes o No o

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

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

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

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

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

Item 17 o Item 18 o

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

Yes o No x

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PRESENTATION OF INFORMATION

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

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds (pounds sterling , sterling or £), the lawful currency of the UK. In this annual report, references to pence and p are to one-hundredth of one pound sterling; references to US dollars , US$ or $ are to the lawful currency of the United States (the US); references to cent or c are to one-hundredth of one US dollar; references to euro or e are to the lawful currency of the member states of the European Union that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to euro cent are to one-hundredth of one euro; and references to Japanese yen , Japanese ¥ or ¥ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2009, which was $1.6167 = £1.00. The Noon Buying Rate on 31 December 2009 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

BUSINESS OVERVIEW

Lloyds Banking Group is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to personal and corporate customers. At 31 December 2009, total Lloyds Banking Group assets were £1,027,255 million and Lloyds Banking Group had some 107,000 employees (on a full-time equivalent basis). Lloyds Banking Group plc s market capitalisation at that date was some £32,327 million. The profit before tax for the 12 months to 31 December 2009 was £1,042 million and the capital ratios as at that date were 12.4 per cent for total capital, 9.6 per cent for tier 1 capital and 8.1 per cent for core tier 1 capital.

Set out below is the Group s summarised income statement for the last two years:

	2009	2008[1]
	£m	£m
Net interest income	**9,026**	7,718
Other income	**36,271**	(709)
Total income	**45,297**	7,009
Insurance claims	**(22,019)**	2,859
Total income, net of insurance claims	**23,278**	9,868
Operating expenses	**(15,984)**	(6,100)
Trading surplus	**7,294**	3,768
Impairment	**(16,673)**	(3,012)
Share of results of joint ventures and associates	**(752)**	4
Gain on acquisition	**11,173**	
Profit before tax	**1,042**	760

1 Restated for IFRS 2 (Revised).

Lloyds Banking Group was formed in January 2009 following the acquisition of HBOS and the Group s main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision. Services are offered through a number of well recognised brands including Lloyds TSB, Halifax, Bank of Scotland, Scottish Widows, Clerical Medical and Cheltenham & Gloucester, and via a distribution capability comprising the largest branch network in the UK and intermediary channels. The new Group also operates an international banking business with a global footprint in over 30 countries.

Since the acquisition of HBOS in January 2009 there have been four primary operating divisions, which constitute the Group s reporting segments: Retail, Wholesale, Wealth and International, and Insurance. Retail provides banking, mortgages and other financial services to personal customers in the UK. Wholesale provides banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers and manages Lloyds Banking Group s activities in financial markets through its treasury function. Wealth and International provides private banking, wealth and asset management in the UK and overseas and corporate, commercial and retail banking services outside the UK. Insurance offers life assurance, pensions and investment products in the UK and Europe and provides general insurance to personal customers in the UK.

The acquisition of HBOS plc on 16 January 2009 has had a significant effect on the comparability of the Group s financial position and results with prior periods. Profit before tax is analysed further on pages 13 to 23 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group s segments, on pages 25 to 40 on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described on page 25. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group s internal reporting based around these segments (which reflect the Group s organisational and management structures) in order to assess performance and allocate resources; this reporting is on a combined businesses basis, which the Group Executive Committee feel best represents the underlying performance of the Group. These combined businesses segmental results for 2009 and 2008 are therefore presented in compliance with IFRS 8 but the aggregated total of the combined businesses segmental results constitutes a non-GAAP measure as defined in the SEC s Regulation G and a reconciliation of this aggregated total to the statutory income

statement is therefore provided on page 39. The following table shows the results of Lloyds Banking Group s Retail, Wholesale, Wealth and International, and Insurance segments and Central group items in the last two fiscal years, and their aggregation.

	2009 £m	2008 £m
Retail	**1,382**	2,542
Wholesale	**(4,703)**	(10,479)
Wealth and International	**(2,356)**	277
Insurance	**975**	1,540
Group Operations and Central items:		
Group Operations	**(149)**	(76)
Central items	**(1,449)**	(517)
	(1,598)	(593)
Loss before tax Combined businesses basis	**(6,300)**	(6,713)

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

SELECTED CONSOLIDATED FINANCIAL DATA

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

	2009	2008[1]	2007[1]	2006[1]	2005[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**23,278**	9,868	10,696	11,098	10,543
Operating expenses	**(15,984)**	(6,100)	(5,568)	(5,300)	(5,481)
Trading surplus	**7,294**	3,768	5,128	5,798	5,062
Impairment losses	**(16,673)**	(3,012)	(1,796)	(1,555)	(1,299)
Gain on acquisition	**11,173**				
Profit before tax	**1,042**	760	3,999	4,249	3,810
Profit for the year	**2,953**	798	3,320	2,908	2,545
Profit for the year attributable to equity shareholders	**2,827**	772	3,288	2,804	2,483
Total dividend for the year[2]		648	2,026	1,928	1,915
Balance sheet data at 31 December (£m)					
Share capital	**10,472**	1,513	1,432	1,429	1,420
Shareholders equity	**43,278**	9,393	12,141	11,155	10,195
Customer deposits	**406,741**	170,938	156,555	139,342	131,070
Subordinated liabilities	**34,727**	17,256	11,958	12,072	12,402
Loans and advances to customers	**626,969**	240,344	209,814	188,285	174,944
Total assets	**1,027,255**	436,033	353,346	343,598	309,754
Share information					
Basic earnings per ordinary share[3]	**7.5p**	6.7p	28.9p	24.8p	22.0p
Diluted earnings per ordinary share[3]	**7.5p**	6.6p	28.7p	24.5p	21.8p
Net asset value per ordinary share	**68p**	155p	212p	195p	180p
Total dividend per ordinary share[2]		11.4p	35.9p	34.2p	34.2p
Equivalent cents per share[2,4]		20.3c	71.0c	67.0c	62.2c
Market price per ordinary share (year end)	**50.7p**	126.0p	472.0p	571.5p	488.5p
Number of shareholders (thousands)	**2,834**	824	814	870	920
Number of ordinary shares in issue (millions)[5]	**63,775**	5,973	5,648	5,638	5,603
Financial ratios (%)[6]					
Dividend payout ratio		83.9	61.6	68.7	77.1
Post-tax return on average shareholders equity	**8.8**	7.0	28.1	26.6	25.5
Post-tax return on average assets	**0.28**	0.21	0.94	0.88	0.83
Average shareholders equity to average assets	**3.0**	2.9	3.3	3.2	3.2
Cost:income ratio[7]	**68.7**	61.8	52.1	47.8	52.0
Capital ratios (%)[8]					
Total capital	**12.4**	11.2	11.0	10.7	10.9
Tier 1 capital	**9.6**	8.0	8.1	8.2	7.9

1 Restated for IFRS 2 (Revised).

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

[3] Earnings per share calculations for 2008 and earlier years have also been restated for the impact of the bonus element of the share issues in 2009.

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

[5] This figure excludes the limited voting ordinary shares owned by the Lloyds TSB Foundations.

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

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

[8] Capital ratios for 2008 and later years are in accordance with Basel II requirements; ratios for 2007 and earlier years reflect Basel I.

EXCHANGE RATES

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

	2010 April	2010 March	2010 February	2010 January	2009 December	2009 November
US dollars per pound sterling:						
High	**1.55**	**1.53**	**1.60**	**1.64**	**1.66**	**1.68**
Low	**1.52**	**1.49**	**1.52**	**1.59**	**1.59**	**1.64**

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

	2009	2008	2007	2006	2005
US dollars per pound sterling:					
Average	**1.57**	1.84	2.01	1.86	1.81

On 30 April 2010, the latest practicable date, the US dollar Noon Buying Rate was $1.5308 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company s issued ordinary share capital. Following the issue of ordinary shares in February 2010 pursuant to the Group s capital raising announced in November 2009, the UK Government s holding was reduced to approximately 41.3 per cent.

STRATEGY OF LLOYDS BANKING GROUP

The Group s corporate strategy supports its vision of being recognised as the best financial services company in the UK by customers, colleagues and shareholders. The strategy is focused on being a conservative,   through the cycle   relationship-based business.

The main focus for the Group remains the financial services markets in the UK and the Group s strategic position was strengthened through the acquisition of HBOS in January 2009. The Group is a well diversified UK financial services group and the largest retail financial services provider in the UK. The Group has leading positions in many of the markets in which it participates, a market leading distribution capability, well recognised brands and a large customer base. The scale of the organisation provides the opportunity to further invest in products and services, systems and training that combined will offer improved choice and service to the Group s customers. The effective integration of the two businesses will be a significant challenge over the next few years, but comprehensive plans are in place and progress is already being made.

The Group s corporate strategy is focused on:

DEVELOPING STRONG CUSTOMER FRANCHISES THAT ARE BASED ON DEEP CUSTOMER RELATIONSHIPS

The Group s businesses are focused on extending the reach and depth of its customer relationships, whilst enhancing product capabilities to build competitive advantage. Striving to understand and effectively meet the needs of the Group s customers from core banking products to the more specialist services such as insurance, wealth management or corporate banking is at the heart of the Group s business and is fundamental to ensuring that the Group is developing long-lasting customer relationships.

BUILDING A HIGH PERFORMANCE ORGANISATION

In building a high performance organisation the Group is focused on improving its cost efficiency and utilising its capital more effectively whilst maintaining a prudent approach to risk.

BUSINESS

The Group aspires to have one of the lowest cost: income ratios amongst UK financial institutions and further improving the Group s processing efficiency and effectiveness will remain a priority. The anticipated synergies arising from the acquisition will be key to further improving the Group s efficiency.

Utilising capital more effectively is increasingly important in the current environment and capital will be rigorously allocated across the Group s portfolio of businesses to support business growth.

The prudent Lloyds TSB through the cycle approach to risk has been applied to the enlarged Group. The Group s conservative and prudent approach to risk is core to the business model and the through the cycle approach means that the Group will continue to support its customers throughout the economic cycle. The risk structures and frameworks that have been implemented are the foundation for good business management.

MANAGING THE GROUP S MOST VALUABLE RESOURCE, PEOPLE

Executing the Group s strategy effectively will only be possible if the Group ensures that deliverables are effectively aligned with its corporate strategy and it manages its most valuable resource, people, well. In driving performance it is important to encourage, manage and develop staff whilst creating a great place to work.

SUMMARY

The Group believes that the successful execution of its strategy to focus on core markets, customer and cost leadership, capital efficiency, a prudent risk appetite and the effective management of its most valuable resource, its people, will bring the Group closer to achieving its vision of being recognised as the best financial services company in the UK.

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

At 31 December 2008, the Group s activities were organised into three segments: UK Retail Banking; Insurance and Investments; and Wholesale and International Banking. Following the acquisition of HBOS plc on 16 January 2009, the Group was reorganised into four segments: Retail; Wholesale; Wealth and International; and Insurance. The Group has restated its segmental information for 2008. The Group has determined that the cost to develop the information required to restate 2007 was excessive. In order to provide comparability with the segmental information for 2007 the Group has supplementally presented its segmental information for 2008 on a consistent statutory basis (see also note 4 to the consolidated financial statements).

Further information on the current and previous segments is set out on pages 25 to 50.

MATERIAL CONTRACTS

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

In 2008, the Company entered into a placing and open offer agreement with The Commissioners of Her Majesty s Treasury (HM Treasury) and the joint sponsors and joint bookrunners named therein, as well as a preference share subscription agreement with HM Treasury, both with effect from 13 October 2008. Prior to the completion of the acquisition of HBOS, HBOS also entered into a placing and open offer agreement with HM Treasury and the joint sponsors and joint bookrunners named therein, as well as a preference share subscription agreement with HM Treasury, both with effect from 13 October 2008.

In 2009, the Company entered into a placing and compensatory open offer agreement with HM Treasury (as amended and restated on 20 March 2009 between the Company, HM Treasury, Citigroup Global Markets U.K. Equity Limited, J.P. Morgan Cazenove Limited and UBS Limited and further amended and restated between the same parties on 18 May 2009). In addition, the Company entered into a registration rights agreement with HM Treasury on 12 January 2009 (as amended with effect from 11 June 2009) pursuant to an obligation to do so under the 2008 placing and open offer agreement referred to above. The Company also entered into a resale rights agreement with HM Treasury pursuant to its obligations under the 2009 placing and open offer agreement. The Company entered into a Pre-Accession Commitments Deed dated 7 March 2009 and a Lending Commitments Deed dated 6 March 2009 (as amended on 23 March 2010) with HM Treasury, both relating to the Company s proposed participation in the Government Asset Protection Scheme. In addition, in connection with the 2009 rights issue and the Group s withdrawal from its proposed participation in the Government Asset Protection Scheme, the Company entered into a GAPS Withdrawal Deed with HM Treasury as well as the HMT Undertaking to Subscribe and the Cost Reimbursement Deed. For further details on each of the 2008 and 2009 agreements described above, see *Major shareholders and related party transactions Information about the Lloyds Banking*

Group s relationship with the UK Government.

In addition to those agreements discussed above, the Company entered into the following agreements, which it considers to be material:

RIGHTS ISSUE UNDERWRITING AGREEMENT

Pursuant to an underwriting agreement dated 3 November 2009 (entered into in relation to the 2009 rights issue described in *Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government* between the Company, the banks, the senior co-lead managers, the co-lead managers and the co-bookrunner (all as named therein)), new shares in the Company were issued at a price of 37 pence per share. Sufficient new shares were issued to ensure that the gross proceeds of the rights issue receivable by the Company, including pursuant to the HMT Undertaking to Subscribe, were not less than £13.5 billion.

HM Treasury undertook to subscribe for its pro rata entitlement under the rights issue and the new shares that were the subject of the HMT Undertaking to Subscribe were not underwritten pursuant to the Rights Issue Underwriting Agreement. Further details of the HMT Undertaking to Subscribe are set out in *Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government*.

In consideration of their services under the Rights Issue Underwriting Agreement, (i) the underwriters (as named in the Rights Issue Underwriting Agreement) were paid an aggregate base fee of 2.25 per cent of the issue price multiplied by the aggregate number of new shares issued (excluding the new shares that were subscribed by HMT), and (ii) the joint bookrunners (as named in the Rights Issue Underwriting Agreement) were paid additional performance-based discretionary fees. Out of such fees (to the extent received by the joint global co-ordinators (as named in the Rights Issue Underwriting Agreement), the joint global co-ordinators were to pay any sub-underwriting commissions (to the extent that sub-underwriters were procured). The joint global co-ordinators had the ability to arrange sub-underwriting in respect of some, all or none of the new shares issued (other than the new shares to be subscribed by HM Treasury).

The Company agreed to pay all costs and expenses of, or in connection with, the rights issue, the general meeting of the Company convened to approve the rights issue, the related subdivision of the Company s shares, the allotment and issue of the new shares and the Rights Issue

BUSINESS

Underwriting Agreement, including (but not limited to) the UK Listing Authority and the London Stock Exchange listing and trading fees, other regulatory fees and expenses, printing and advertising costs, postage, Equiniti Limited s charges (as registrar), its own and the banks , the senior co-lead managers and the co-lead managers properly incurred legal and other out of-pocket expenses, all accountancy and other professional fees, properly incurred public relations fees and expenses and all stamp duty and stamp duty reserve tax (if any) and other duties and taxes (other than corporation tax incurred by any of the banks, the senior co-lead managers and the co-lead managers on the commissions payable to them).

The obligations of the banks, the senior co-lead managers and the co-lead managers under the Rights Issue Underwriting Agreement were subject to certain limited conditions which were satisfied.

TOP UP ISSUES UNDERWRITING AGREEMENT

Pursuant to the Top Up Issues Underwriting Agreement dated 3 November 2009 among the Company, LBG Capital No.2 plc (as issuer), Lloyds TSB Bank plc (as guarantor) and the joint bookrunners (as named therein), in the event that the exchange offers described in *Risk factors Government-related risks* did not generate or were not expected to generate prior to 30 April 2010, or such other date as the Company and the joint bookrunners might agree, £7.5 billion or more of core tier 1 and/or nominal value of contingent core tier 1 capital, the joint bookrunners severally agreed to underwrite one or more further issues of enhanced capital notes in an aggregate amount sufficient to reduce such shortfall to zero by such date.

In consideration of their underwriting services under the Top Up Issues Underwriting Agreement, and subject to their obligations under the Top Up Issues Underwriting Agreement having become unconditional and the Top Up Issues Underwriting Agreement not having been terminated, the joint bookrunners were to be paid an aggregate underwriting fee of £75 million and additional performance-based discretionary fees.

The obligations of the joint bookrunners under the Top Up Issues Underwriting Agreement and, in relation to each issue of additional enhanced capital notes, the obligations of the joint bookrunners under the Top Up Issues Underwriting Agreement were subject to certain conditions which were satisfied.

Each of the Company, the issuer and the guarantor gave certain customary representations, warranties, undertakings and indemnities to the joint bookrunners, all of which have now expired.

In addition to the fees described above, the joint bookrunners and their affiliates were to be paid pursuant to the Rights Issue Underwriting Agreement and the Top Up Issues Underwriting Agreement:

(a) an aggregate transaction praecipuum of 0.088 per cent of £15.1 billion (being the aggregate of the underwriting commitments of the underwriters and the joint bookrunners), or of a sum in excess thereof dependent on the notional amount of the securities submitted in the exchange offers; and

(b) a further discretionary aggregate transaction praecipuum (to be paid at the sole discretion of the Company, as to payment and allocation) of 0.088 per cent of £15.1 billion (being the aggregate of the underwriting commitments of the underwriters and the joint bookrunners), or of a sum in excess thereof dependent on the notional amount of the securities submitted in the exchange offers.

ENVIRONMENTAL MATTERS

The Group has a long-standing commitment to managing its environmental impacts. It first introduced an environmental policy in 1996. In 2009, the Group reviewed the policy against best practice to ensure that it is fit for purpose across the whole of the Group. Further work will be undertaken during 2010 to produce and embed an enhanced and integrated environmental management system.

CLIMATE CHANGE

The UK Government is committed to reducing the country s carbon emissions by 80 per cent from 1990 levels by 2050. A central part of its strategy is the introduction of a mandatory climate change and energy savings scheme, the Carbon Reduction Commitment Energy Efficiency Scheme, due to start in April 2010. The Group qualifies as a participant in this scheme, which requires a collective 22 per cent emissions reduction from participants by 2012. The Group fully understands its obligations and is committed to driving down CO_2 emissions. It is developing a carbon management policy and strategy to deliver a single approach

for the new combined Group, and continues to invest significant capital in carbon reduction projects across the Group s estate.

In 2009 the Group chaired an initiative with Business in the Community and the Cambridge Programme for Sustainability Leadership to create a Guide for Carbon Management in the Supply Chain. The guide has helped inform the Group s approach and, as a freely downloadable resource, the Group is also encouraging its suppliers and customers to use it to help manage carbon risks in the supply chain.

Lloyds Banking Group is represented by Group Executive Director Truett Tate on the Corporate Leaders Group on Climate Change . This group of leading businesses released the Copenhagen Communiqué , widely viewed as the progressive voice of business, for the Copenhagen Climate Change talks in December 2009.

BUSINESS TRAVEL

In 2009 the Group introduced a common travel policy across the organisation. It supports a focus on sustainable travel and helped the Group deliver a 13 per cent reduction in the costs of travel.

The Group s Sustainability Network holds events and runs awareness campaigns to encourage colleagues to play their part. Travel reduction was one of the Network s key themes in 2009, inspiring colleagues to take steps to reduce their travel footprints.

The Group achieved a reduction of 143,000 journeys in 2009 compared with 2008. Across the combined Group, the volume of teleconferences increased by over 40 per cent to over 1.1 million. The Group will continue to promote virtual conferencing technologies to colleagues as an environmentally friendly, cost efficient alternative to travelling.

ENVIRONMENTAL RISK MANAGEMENT

The Group has introduced policies and procedures to reduce the environmental impact of its lending activities. The Group aims to reduce environmental impacts through effective risk management. In 2009 it implemented an integrated groupwide environmental risk policy to manage these risks; this requires transactions to be assessed for material risks as part of the credit sanctioning process.

BUSINESS

EQUATOR PRINCIPLES

The Equator Principles are voluntary guidelines for the financial industry to manage social and environmental issues in project financing. Lloyds Banking Group is a signatory to the Equator Principles.

During 2009 the Group implemented a harmonised groupwide approach to monitoring and reporting Equator Principles transactions, and training colleagues on the Equator Principles. An Equator Principles Review Group has been formed, comprising experts from both Risk and Project Finance teams, and supported by external environmental consultants. This Group is responsible for reviewing all new Equator Principle transactions, to ensure that each transaction is compliant and is consistent with the group environmental risk policy, prior to being sanctioned.

Equator Principles reporting January to December 2009:

DEALS

	Equator Principle risk category			
	Category A higher risk	Category B medium risk	Category C lower risk	Total
Completed		7	7	14
In progress		4	1	5
Not completed		1		1
		12	8	20

GEOGRAPHY OF COMPLETED TRANSACTIONS

	Category A higher risk	Category B medium risk	Category C lower risk	Total
US		2	2	4
Europe		4	5	9
Middle East		1		1
		7	7	14

INDUSTRY OF COMPLETED TRANSACTIONS

	Number	£m
Renewables	4	89
Infrastructure	7	376
Energy and utilities	3	72
	14	537

PROPERTIES

As at 31 December 2009, Lloyds Banking Group occupied 3,467 properties in the UK. Of these, 953 were held as freeholds, 98 as long-term leaseholds and 2,416 as short-term leaseholds. The majority of these properties are retail branches, widely distributed throughout England, Scotland and Wales. Other buildings include the Lloyds Banking Group s head office in the City of London and customer service and support centres located to suit business needs but clustered largely in London, Birmingham, West Yorkshire, Chester and Bristol (in England), Edinburgh (in Scotland) and Cardiff and Newport (in Wales).

In addition, there are 699 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as short-term leasehold. In addition, the Group also owns, leases or uses under licence properties for business operations elsewhere in the world, principally in Spain, Switzerland, Dubai, Asia and Ireland.

LEGAL ACTIONS

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory challenge both in the UK and overseas.

UNARRANGED OVERDRAFT CHARGES

In April 2007, the OFT commenced an investigation into the fairness of personal current accounts and unarranged overdraft charges. At the same time, it commenced a market study into wider questions about competition and price transparency in the provision of personal current accounts.

The Supreme Court published its judgment in respect of the fairness of unarranged overdraft charges on personal current accounts on 25 November 2009, finding in favour of the litigant banks. On 22 December 2009, the OFT announced that it will not continue its investigation into the fairness of these charges. The Group is working with the regulators to ensure that outstanding customer complaints are concluded as quickly as possible and anticipate that most cases in the county courts will be discontinued. The Group expects that some customers will argue that despite the test case ruling they are entitled to a refund of unarranged overdraft charges on the basis of other legal arguments or challenges. The Group is robustly defending any such complaints or claims and does not expect any such complaints or claims to have a material effect on the Group.

The OFT however continued to discuss its concerns in relation to the personal current account market with the banks, consumer groups and other organisations under the auspices of its Market Study into personal current accounts. In October 2009, the OFT published voluntary initiatives agreed with the industry and consumer groups to improve transparency of the costs and benefits of personal current accounts and improvements to the switching process. On 16 March 2010 the OFT published a further update announcing several further voluntary industry wide initiatives to improve a customer s ability to control whether they used an unarranged overdraft and to assist those in financial difficulty. However, in light of the progress it noted in the unarranged overdraft market since July 2007 and the progress it expects to see over the next two years, it has decided to take no further action at this time and will review the unarranged overdraft market again in 2012. The OFT also announced it will shortly be commencing an investigation into the barriers to entry in the personal current accounts market.

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INTERCHANGE FEES

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the General Court). Lloyds TSB Bank plc and Bank of Scotland plc (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard s position that the arrangements for the charging of a uniform fallback interchange fee are compatible with European Commission competition laws. MasterCard has announced that it has reached an understanding with the European Commission on a new methodology for calculating intra European Economic Area multi-lateral interchange fees on an interim basis pending the outcome of the appeal. Meanwhile, the European Commission and the UK s OFT are pursuing investigations with a view to deciding whether arrangements adopted by other payment card schemes for the levying of uniform fallback interchange fees in respect of domestic and/or cross-border payment transactions also infringe European Commission and/or UK competition laws. As part of this initiative, the OFT will also intervene in the General Court appeal supporting the European Commission position and Visa reached an agreement with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by MasterCard. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

PAYMENT PROTECTION INSURANCE

UK COMPETITION COMMISSION

In January 2009, the Competition Commission completed its formal investigation into the supply of Payment Protection Insurance (PPI) services (except store card PPI) to non-business customers in the UK. Various members of the Group underwrite PPI, while other members distribute PPI, by offering it for sale with a variety of the credit products which they supply.

On 5 June 2008, the Competition Commission issued its provisional findings, to the effect that there are market features which prevent, restrict or distort competition in the supply of PPI to non-business customers, with an adverse effect on competition and with the result being detrimental to consumers.

Following consultation, the Competition Commission published its final report on 29 January 2009 setting out its remedies. In summary, the Competition Commission has decided to adopt the following remedies: (i) a prohibition on the active sale of PPI by a distributor to a customer within seven days of the distributor s sale of credit to that customer. However, customers may pro-actively return to the distributor to initiate a purchase by telephone or online from 24 hours after the credit sale; (ii) a requirement on all PPI providers to provide certain information and messages in PPI marketing materials; (iii) a requirement to provide personal PPI quotes to customers; (iv) a requirement on all PPI providers to provide certain information on PPI policies to the FSA; (v) a recommendation to the FSA that it use the information provided under the requirement in (iii) to populate its PPI price comparison tables; (vi) a requirement on distributors to provide an annual statement for PPI customers containing information on their PPI policy and what it costs; and (vii) a prohibition on the levying by distributors of payments for PPI on a single premium basis. Instead, distributors are permitted to charge only regular premiums at a constant rate, paid monthly or annually. This remedy therefore precludes the selling of multi-year PPI policies for a single premium.

On 30 March 2009, Barclays Bank PLC lodged an appeal in the Competition Appeal Tribunal against the Competition Commission s findings. In particular, it requested that the Competition Appeal Tribunal quash the decision of the Competition Commission insofar as it relates to the prohibition of distributors selling PPI at the credit point of sale and the Competition Commission s findings on market definition and the nature and extent of competition in the supply of PPI. The Group filed a notice of its intention to intervene in the appeal on 23 April 2009. On 28 April 2009, the Group was granted permission by the Competition Appeal Tribunal to intervene in the appeal. The hearing of the appeal took place from 7 September 2009 to 11 September 2009. The Competition Appeal Tribunal handed down its judgment on 16 October 2009. It found in favour of Barclays in respect of its challenge to the Competition Commission s prohibition of distributors selling PPI at the credit point of sale but it did not uphold Barclays challenge to the Competition Commission s findings on market definition. The matter has been referred back to the Competition Commission with direction to reconsider their remedies and make a new decision in accordance with the Competition Appeal Tribunal s ruling. This may or may not result in the Competition Commission ultimately reaching a different conclusion.

Depending on the outcome of the referral back to the Competition Commission, the Competition Commission s decision may have a significant adverse impact on the level of sales and thus the revenue generation and profitability of the payment protection insurance products which the Group offers its customers, but the ultimate impact would be determined by a number of factors

including the extent to which the Group was able to mitigate the potentially adverse effects of such statutory changes through restructuring the payment protection products which it offers its customers and/or developing alternative products and revenue streams. To this end, the Group took a commercial decision to sell only regular monthly premium PPI to its personal loan customers in the UK from early 2009. The FSA subsequently wrote to certain other firms still selling single premium PPI with unsecured personal loans asking them to withdraw the product as soon as possible, and no later than 29 May 2009.

On 1 July 2008, the Financial Ombudsman Service referred concerns regarding the handling of PPI complaints to the FSA as an issue of wider implication. The Group has been working with other industry members and trade associations in preparing an industry response to address regulatory concerns regarding the handling of PPI complaints. On 29 September 2009, the FSA issued a consultation paper on PPI complaints handling. The FSA has escalated its regulatory activity in relation to past PPI sales generally and has proposed new guidance on the fair assessment of a complaint and the calculation of redress and a new rule requiring firms to reassess historically rejected complaints. On 9 March, the FSA issued a further consultation paper on this area, the consultation period for which closed on 22 April (the Group has responded to this consultation). The FSA s proposals are materially the same, although it has placed the new rule requiring firms to reassess historically rejected claims on hold for the present.

The statement on 29 September 2009 also announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. The Group has subsequently agreed in principle that it will undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. The precise details of the review are still being discussed with the FSA. The ultimate impact on the Group of any review and/or the FSA s complaints handling proposals can only be known at the conclusion of these discussions and on publication of the FSA s final rules.

US ECONOMIC SANCTIONS

Starting in 2007 Lloyds TSB Bank plc provided information in relation to its review of historic US Dollar payments involving countries, persons or entities subject to US economic sanctions administered by the Office of Foreign Assets Control (OFAC) to a number of authorities reported to be conducting a review of sanctions compliance by non-US financial institutions. On 9 January 2009 the settlement reached by Lloyds TSB Bank plc with both the US Department of Justice and the New York County District Attorney s Office in relation to their investigations was announced. The

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settlement documentation contains details of the results of the investigations including the identification of certain activities relating to Iran, Sudan and Libya which Lloyds TSB Bank plc conducted during the relevant period. In 2008, Lloyds TSB Bank plc made a provision of £180 million which fully covered the settlement amount paid to the Department of Justice and the New York District Attorney s Office. On 22 December 2009 OFAC announced the settlement it had reached with Lloyds TSB Bank plc in relation to its investigation and confirmed that the settlement sum due to OFAC had been fully satisfied by Lloyds TSB Bank plc s payment to the Department of Justice and the New York District Attorney s Office. No further enforcement actions are expected in relation to the matters set out in the settlement agreements. A purported shareholder filed a derivative civil action in the Supreme Court of New York, Nassau County on 26 February 2009 against certain current and former directors, and nominally against Lloyds TSB Bank plc and the Company, seeking various forms of relief following the settlement. The derivative action is at a very early stage, but the ultimate outcome of the action is not expected to have a material impact on the Group.

OTHER LEGAL ACTIONS

In addition to the matters listed above the Group is subject to threatened or actual legal proceedings and regulatory challenge both in the UK and overseas. 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 to properly assess the merits of the case and no provisions are held against such cases. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position.

COMPETITIVE ENVIRONMENT

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

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

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

UK Government, EU or other intervention in the banking sector may impact the competitive position of banks within a country and among international competitors which may be subject to different forms of intervention, thus potentially putting the Group at a competitive disadvantage to other banks.

RECENT DEVELOPMENTS

SHARE CAPITAL

As part of the Group s recapitalisation and withdrawal from its proposed participation in the Government Asset Protection Scheme the Group announced on 23 November 2009 that an aggregate amount of £1.48 billion would be issued in the form of new ordinary shares of Lloyds Banking Group plc in exchange for certain existing preference shares and preferred securities. The conversion price was determined as the five day weighted average price for the five trading days ending on 11 February 2010.

On 18 February 2010, the exchange completed and 3,141 million ordinary shares in Lloyds Banking Group plc were issued as consideration for the redemption of preference shares and preferred securities. In accordance with the Group s accounting policy in

respect of debt for equity exchanges, a gain of £85 million will be recognised on this exchange transaction in the year ended 31 December 2010.

SALE OF ESURE

On 11 February 2010, the Group announced the sale of its 70 per cent stake in esure, the online insurer, to a management buyout vehicle to be called esure Group Holdings Limited, led by the esure chairman, for a cash consideration slightly in excess of book value in the Lloyds Banking Group accounts. The impact on the Group s accounts is not expected to be material.

TRADING UPDATE 19 MARCH 2010

The Group issued an update on its current trading on 19 March 2010, which included the following comments:

In the first 10 weeks of 2010, the Group s trading performance has been strong and we are pleased with the Group s performance against each area of recent guidance. The banking net interest margin is trending in line with recent guidance and this has supported a good level of income growth, on a combined businesses basis and excluding last year s gains from liability management transactions.

Costs have remained well controlled and are lower than the equivalent period in 2009. Impairment provisions are currently trending at lower levels than anticipated and as a result the Group now expects to deliver a better impairment performance than previously guided, in both the retail and corporate businesses, in 2010. Overall, based on the Group s current economic and regulatory assumptions which remain unchanged since our recent 2009 preliminary results announcement, the Group believes that it will be profitable on a combined businesses basis (see *Operating and financial review and prospects Line of business information 2009 compared to 2008* and *Combined businesses basis summary 2009 compared with 2008*) in 2010.

BOARD CHANGES

On 11 February 2010, the Group announced the appointment of Glen Moreno and David Roberts as directors with effect from 1 March 2010. On 22 March 2010, the Group announced that Dr Wolfgang Berndt would retire as a director at the annual general meeting on 6 May 2010.

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INTERIM MANAGEMENT STATEMENT

The Group issued an Interim Management Statement on 27 April 2010, which included the following comments:

The Group is continuing to see positive trends in line with our recent trading update on 19 March 2010. In particular, impairments have slowed significantly in the first few months of the year giving us confidence that we will achieve a better financial performance than previously guided. I am pleased to report that we returned to profitability in the first quarter and expect this momentum to be sustained throughout 2010.

Eric Daniels
Group Chief Executive

Key highlights

In the first quarter of 2010 the Group returned to profitability on a combined businesses basis due mainly to a significant slowing of impairments in the wholesale business (see *Operating and financial review and prospects Line of business information 2009 compared to 2008* and *Combined businesses basis summary 2009 compared to 2008*).

The Group is delivering good income growth, on a combined businesses basis, excluding last year s impact from liability management transactions.

Banking net interest margins are running in line with recent guidance of circa 2 per cent for the full year.

Costs continue to be well controlled and remain lower than the equivalent period in 2009. Integration savings are being delivered in line with recent guidance and the Group remains on track to achieve a £2 billion run-rate of synergies and other operating efficiencies by the end of 2011.

The run rate of impairments has slowed significantly and has continued to perform better than our 2009 preliminary results guidance in both retail and corporate businesses.

Customer deposit gathering has remained robust, with good growth in balances, while lending balances are flat. Asset reductions within the Group s portfolios identified for run-off continue albeit, as expected, at a slower pace than last year.

The Group continues to de-risk its funding position, with strong term issuance in the early part of the year while continuing to maintain high levels of liquid assets.

Good trading performance with guidance reaffirmed

The Group is continuing to see good income growth on a combined businesses basis (excluding the impact of liability management exercises). In particular, margin improvements have more than offset the impact of asset reductions over the last year.

Overall banking margins are trending positively and we continue to be confident of delivering a circa 2 per cent margin for the full year.

Income in the Group s core banking businesses has continued to benefit from higher asset pricing and lower funding costs. Good progress continues to be made in improving the quality of both sides of our balance sheet as we continue to grow our customer relationship focused assets and deposits, whilst running down our non-core assets. Deposit gathering activities during the first quarter have seen continued good momentum, particularly in the Retail business where we have built on the strong product sales over the last 12 months and delivered good levels of growth in both current account and savings balances. In our Wealth business income levels were supported further by improved equity market conditions.

In Insurance, new business sales are modestly lower than the equivalent period of last year. However our decision in 2009 to refocus certain product offerings to improve returns is having a favourable impact on the profitability of those products.

The Group s strong track record of effective cost control continues to yield benefit. The integration programme is progressing well and synergy savings continue to be delivered in line with the recent guidance. As a result, the Group remains on track to deliver on its commitment to a £2 billion run-rate of synergies and other operating efficiencies by the end of 2011.

Impairments have slowed significantly as a result of proactive management and more benign economic conditions and we continue to see lower impairments in both our Retail secured and unsecured lending portfolios. In our Wholesale division, the level of impairments has been significantly lower than the last quarter of 2009 and is also at a lower level than our initial expectations for 2010. In our Wealth and International division, impairments continue at a high level, principally as a result of further provisions in Ireland relating to our commercial real estate portfolio; however, the level of impairments in the first quarter of 2010 was lower than the last quarter of 2009 and we continue to believe that we are past the peak for impairment losses in the division. We remain vigilant to changes in economic conditions and to individual lending positions and continue to monitor the position of the Irish economy in particular.

The Group is pleased to have returned to profitability, on a combined businesses basis, in the first quarter. Based on the Group s current economic and regulatory assumptions we expect this trend to continue and for the Group to deliver a combined businesses profit at both the half and full year.

Further strengthening of the balance sheet position

Customer deposits have grown robustly during the first quarter by over £5 billion, mainly in our Retail division. We are supporting our relationship customers and the economy by continuing to lend. Lending balances have remained flat overall, with assets within the Group s run-off portfolios continuing to reduce, albeit at a slower pace than last year. Our assets continue to be appropriately priced for risk and funding costs and risk-weighted assets remain broadly unchanged to the position at the end of 2009.

Since the start of 2010, we have seen further improvements in wholesale funding market conditions and we are pleased with progress on our public term issuance so far this year. The Group continues to maintain a substantial liquid asset portfolio which is now broadly equivalent to the proportion of our wholesale funding (including bank deposits) which has a maturity of less than one year. In addition, the Group has maintained the maturity profile of wholesale funding such that 50 per cent has a maturity date of over one year.

As a result, the Group has continued to improve its liquidity and funding position, further de-risking the balance sheet.

The foregoing trading update and interim management statement include certain forward looking statements with respect to management s expectations for the Group s financial condition and performance, which by their nature involve risk and uncertainty. See *Forward looking statements* and *Risk factors* for a discussion of factors that could cause actual results to differ materially from the expectations expressed in such forward looking statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OVERVIEW AND TREND INFORMATION

THE ECONOMY

2009 has been a mixed year in terms of economic developments. With an estimated fall of 5 per cent, UK GDP growth was towards the bottom end of the Group s, and the market s, range of expectations. The UK experienced the biggest recorded single-year GDP fall since the 1930s, and the peak to trough decline in GDP currently matches the early 1980s recession (see chart 1). The downturn in most other industrialised economies was of similar magnitude. In response, official interest rates have fallen to their lowest level since the Bank of England was founded. Interest rates elsewhere have also fallen to extremely low levels.

CHART 1:

UK GDP IN THE LAST THREE RECESSIONS

CHART 2:

UK EMPLOYMENT IN THE LAST THREE RECESSIONS

CHART 3:

UK COMPANY FAILURES IN THE LAST THREE RECESSIONS

Perhaps partly in response to such low interest rates, other economic indicators have not turned out so badly in 2009 as many had feared.

At the beginning of the year, most commentators would have expected such a sharp drop in GDP to result in much worse unemployment numbers than has been the case. In fact, employment has held up quite well given the severity of the decline in GDP (see chart 2). Similarly, the rate of company failures so far in this downturn has been lower than might have been expected given the severity of the GDP decline (see chart 3).

Companies went into this recession in better shape generally than during the last recession, and seem to have taken early action to cut investment, stocks and working hours. Helped by very low interest rates, the aggregate financial position of the corporate sector has remained strong. This has undoubtedly helped to limit failure rates. And this in turn has probably helped to limit the rise in unemployment the biggest single cause of job losses in most recessions is business failure.

Meanwhile, property prices have also held up better than many forecasters had expected. At the beginning of the year, the average view was that house prices would fall by around 15 per cent during 2009, and decline further in 2010. In fact, the Halifax house price index ended the year higher than twelve months earlier, and other indices showed a similar picture. House prices fell during the early part of the year, but then started to recover in the second half and finished the year still above long-term average levels relative to household incomes, albeit well down on their peak in 2007.

Commercial property prices showed a similar recovery. Having fallen sharply in late 2008 and early 2009, commercial property capital values have stabilised recently, despite continued falls in rental values, and many forecasts for 2009 and 2010 have been revised up. At the end of 2009, the consensus forecast was for modest growth in capital values this year and next, even as rental values decline further.

Looking forward, the most likely immediate economic scenario is one of slow and erratic growth. GDP is estimated to have begun to recover in Q4 2009, and may even have done so earlier once final revisions are made to earlier estimates for Q3. Survey evidence, including purchasing manager indices, was pointing to positive growth in manufacturing and services for most of the second half of 2009. Retail sales growth accelerated in late 2009, although some of this may have been spending brought forward to beat the restoration of Value Added Tax (a UK sales tax) to 17.5 per cent. Unemployment appears to have levelled off, at least temporarily, and actually fell in late 2009. Financial market conditions have continued to normalise, in line with the improving economic outlook. The consensus forecast for 2010 has risen gradually, and by the end of 2009 was suggesting 2010 GDP growth of around 1.5 per cent, close to the Group s own central scenario. This slow recovery is consistent with the sort of upturn seen after past financial crises. But even that below-trend growth relies mainly on a recovery in net external trade and an end to company destocking. Domestic demand growth is likely to be minimal in 2010.

Alternative scenarios remain possible. The Bank of England s most likely outcome, as published in the February 2010 Inflation Report, is for a somewhat faster recovery during 2010 than the consensus forecast. However, the risks around that are skewed towards the downside.

It is possible that the economy will dip again if hit by some new shock and what might start as a temporary setback to recovery could have longer-lasting effects if it damages consumer, business or financial market confidence. Furthermore, uncertainties remain about how the economy will respond as and when the Bank of England begins to reverse quantitative easing and restore interest rates to more normal levels, and the Government begins to take action to reduce the large fiscal deficit.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPACT ON OUR MARKETS

2009 was a year of weakening growth in most of the Group s markets. On the retail side, net new market mortgage lending (i.e. new lending minus repayments) was very low throughout 2009, as a result of which growth in outstanding balances slowed to around 1 per cent by year end. Net new market unsecured consumer lending was very weak in the first half of the year, and turned negative in the second half.

Weakening lending growth appears to have been driven by both supply and demand. Some lenders have pulled back from the market, especially from higher-risk segments. But at the same time, data on the Group s retail customers shows that they have reacted to the recession by prioritising reducing debt. This trend is apparent across all the Group s customer groups, whether split by age, income, or indebtedness. This helps to explain why market deposit growth also weakened in 2009, despite a higher national saving ratio. Households have on average chosen to use the cash freed up by reduced spending and lower debt interest payments to pay off debt rather than save more.

Market mortgage arrears rose during the first half of 2009, but then fell back in the second half. Market credit card arrears also fell during the second half. Improving arrears trends may have been helped by households starting to pay down debt. And many mortgage borrowers will have found their debt servicing costs reduced during 2009 as their variable mortgage rates fell or as their fixed rate loans expired and they rolled off onto lower standard variable rates. Quite strong growth in the average household s real disposable income in 2009 will also have helped, aided by better-than-expected employment levels in the second half and falling inflation.

Businesses also appear to have used 2009 to strengthen their financial position where possible. Sharp cutbacks in investment spending, and in stocks, have enabled businesses in aggregate to remain in financial surplus and reduce their reliance on external credit from banks, trade creditors and others. Large companies have also taken advantage of the recovery in financial markets to increase capital market borrowing thereby further reducing bank credit demand. As a result, the outstanding stock of bank and building society lending to private non-financial businesses declined in 2009, and corporate deposits returned to positive growth despite the weakness of demand in many companies markets. Strengthened corporate finances were probably a major factor limiting the growth in company failures in 2009. Indeed, as chart 3 shows, the rate of company failures reduced in the second half of 2009.

The Group expects that the weakness of likely economic recovery will be mirrored in slow growth of major banking markets in 2010 as both households and businesses continue to restructure their finances. However, 2010 may see company failure rates rise again, since it is typically when companies have to restock to meet an upturn in demand that the financial pressures on them are greatest.

CRITICAL ACCOUNTING POLICIES

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

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

FUTURE ACCOUNTING DEVELOPMENTS

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

RESULTS OF OPERATIONS 2009, 2008 AND 2007

SUMMARY

	2009 **£m**	2008[1] £m	2007[1] £m

Net interest income	**9,026**	7,718	6,099
Other income	**36,271**	(709)	12,119
Total income	**45,297**	7,009	18,218
Insurance claims	**(22,019)**	2,859	(7,522)
Total income, net of insurance claims	**23,278**	9,868	10,696
Operating expenses	**(15,984)**	(6,100)	(5,568)
Trading surplus	**7,294**	3,768	5,128
Impairment	**(16,673)**	(3,012)	(1,796)
Share of results of joint ventures and associates	**(752)**	4	10
Gain on acquisition	**11,173**		
Profit on sale of businesses			657
Profit before tax	**1,042**	760	3,999
Taxation	**1,911**	38	(679)
Profit for the year	**2,953**	798	3,320
Profit attributable to minority interests	**126**	26	32
Profit attributable to equity shareholders	**2,827**	772	3,288
Profit for the year	**2,953**	798	3,320

1 Restated for IFRS 2 (Revised).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2009 COMPARED WITH 2008

Profit before tax was £282 million, or 37 per cent, higher at £1,042 million in 2009 compared to £760 million in 2008; however, the profit in 2009 included a negative goodwill credit of £11,173 million in relation to the acquisition of HBOS plc by the Group; a fee of £2,500 million paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme; and significant post-acquisition impairment losses in respect of the HBOS portfolios.

Total income increased by £38,288 million to £45,297 million in 2009 compared to £7,009 million in 2008. Excluding the total income of £23,240 million arising on the consolidation of HBOS s post-acquisition results, total income was £15,048 million higher at £22,057 million in 2009 compared to £7,009 million in 2008; with a reduction in the Group s net interest income being more than offset by a large increase in other income.

Net interest income was £1,308 million, or 17 per cent, higher at £9,026 million in 2009 compared to £7,718 million in 2008. Excluding the net interest income of £4,049 million arising on the consolidation of HBOS s post-acquisition results, net interest income was £2,741 million, or 36 per cent, lower at £4,977 million in 2009 compared to £7,718 million in 2008. Excluding the interest flows arising on the consolidation of HBOS s post-acquisition results, both interest income and interest expense fell in response to the historically low interest rate environment that prevailed throughout 2009; net interest income was reduced as the benefit of higher asset pricing was more than offset by the impact of lower deposit margins, reflecting the impact of falling base rates, and higher funding costs, which included the impact of the Group extending its wholesale funding maturity profile. The Group s net interest margin decreased by 157 basis points to 1.06 per cent in 2009 compared to 2.63 per cent in 2008 with reductions across the Group s businesses.

Other income was £36,980 million higher at £36,271 million in 2009 compared to a deficit of £709 million in 2008. Fee and commission income was £1,023 million, or 32 per cent, higher at £4,254 million in 2009 compared to £3,231 million in 2008. However, excluding the fee and commission income which arose on the consolidation of HBOS s post-acquisition results, fee and commission income was £479 million, or 15 per cent, lower at £2,752 million in 2009 compared to £3,231 million in 2008, largely due to a £424 million reduction in insurance broking income as a result of a market-wide move to monthly premiums on payment protection products. Net trading income improved by £28,284 million to net income of £19,098 million in 2009 compared to a net loss of £9,186 million in 2008. Excluding net trading income of £12,093 million arising from the consolidation of the post-acquisition results of HBOS, net trading income improved by £16,191 million to net income of £7,005 million in 2009 compared to a net loss of £9,186 million in 2008. Trading income in 2008 in the Group s banking operations was particularly impacted by market dislocation, leading to significant downwards valuations on a number of assets; this was not repeated in 2009. In addition there was an improvement of £14,179 million in gains on policyholder investments held in the Group s insurance businesses (and largely offset by an increase in the claims expense, see below) as the improvement in market conditions has led to trading profits in 2009, compared to substantial losses in 2008. During 2009 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liability of £1,498 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs.

Insurance claims were £24,878 million higher at an expense of £22,019 million in 2009 compared to a credit of £2,859 million in 2008. Excluding the insurance claims expense of £12,385 million arising on the consolidation of HBOS s post-acquisition results, insurance claims were £12,493 million higher at an expense of £9,634 million in 2009 compared to a credit of £2,859 million in 2008. The insurance claims amount in respect of life and pensions business in 2008 was a credit of £3,052 million as a result of the negative returns in that year on policyholder investments in the long-term insurance business which led to a reduction in insurance related liabilities and a credit to the insurance claims expense; positive returns in 2009 have led to the return to an insurance claims expense with the movement in claims being broadly matched by an improvement in net trading income reflecting the gains on policyholder investments. Insurance claims in respect of general insurance business were £441 million higher at £634 million in 2009 compared to £193 million in 2008. Excluding the general insurance claims of £362 million arising on the consolidation of HBOS s post-acquisition results, general insurance claims were £79 million, or 41 per cent, higher at £272 million in 2009 compared to £193 million in 2008, this was due primarily to higher payment protection insurance claims related to unemployment.

Operating expenses increased by £9,884 million, or 162 per cent, to £15,984 million in 2009 compared to £6,100 million in 2008. Excluding the operating expenses of £6,456 million arising on the consolidation of HBOS s post-acquisition results, operating expenses were £3,428 million, or 56 per cent, higher at £9,528 million in 2009 compared to £6,100 million in 2008; this increase principally reflects the £2,500 million fee paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme, costs of £635 million borne within the Lloyds TSB businesses in respect of the integration of the enlarged group and an increased charge in respect of goodwill impairment, only partly offset by the fact that operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments which was not repeated in

2009. Staff costs were £3,697 million, or 124 per cent, higher at £6,675 million compared to £2,978 million in 2008. Excluding the staff costs of £3,014 million that arose on consolidation of the post-acquisition results of HBOS, staff costs were £683 million, or 23 per cent, higher at £3,661 million in 2009 compared to £2,978 million in 2008, with particular increases in restructuring costs and other staff costs (reflecting increased use of agency staff in relation to the integration programme). Premises and equipment costs were £506 million, or 78 per cent, higher at £1,156 million in 2009 compared to £650 million in 2008. Excluding the premises and equipment costs that arose on the consolidation of the post-acquisition results of HBOS, premises and equipment costs were £84 million, or 13 per cent, higher at £734 million in 2009 compared to £650 million in 2008. Other expenses were £1,167 million, or 69 per cent, higher at £2,853 million in 2009 compared to £1,686 million in 2008. Excluding the £1,185 million of costs that arose on consolidation of the post-acquisition results of HBOS, other costs were £18 million, or 1 per cent, lower at £1,668 million in 2009 compared to £1,686 million in 2008; however operating expenses in 2008 included the £180 million settlement in relation to certain historic US dollar payments and, excluding this, operating expenses excluding HBOS in 2009 were £162 million, or 11 per cent, higher at £1,668 million compared to £1,506 million in 2008. Depreciation and amortisation costs were £1,874 million higher at £2,560 million compared to £686 million in 2008; £1,813 million of this increase reflects the impact of consolidation of the post-acquisition results of HBOS. A charge of £240 million (2008: £100 million) arose in respect of the impairment of goodwill attributable to the Group s asset finance business.

Impairment losses increased by £13,661 million to £16,673 million in 2009 compared to £3,012 million in 2008. Excluding the impairment losses of £12,257 million arising from the consolidation of HBOS s post-acquisition results, impairment losses were £1,404 million, or 47 per cent, higher at £4,416 million in 2009 compared to a £3,012 million in 2008; this increase includes £1,664 million in respect of loans and advances to customers and reflects the substantial deterioration in the credit environment; partly offset by a reduction in the charge in respect of loans and advances to banks and other impairment provisions. During 2009, following the acquisition of HBOS, the Group has experienced a significant rise in impairment levels in its lending portfolios. This largely represents falls in the value of commercial real estate and the impact of the economic deterioration during the year, including the effects of rising unemployment and reduced corporate cash flows. The Group has spent a significant amount of time analysing and addressing the issues in the legacy HBOS portfolios, with the greatest attention paid to the over-concentration in real estate related lending and those portfolios that fall outside of the Lloyds TSB risk appetite; and, as a consequence, the Group has taken prudent and material impairment charges in the period following the acquisition.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group s share of results of joint ventures and associates was a net loss of £752 million compared to a net profit of £4 million in 2008. However, excluding the losses of £755 million arising on the consolidation of HBOS s post-acquisition results, the share of results of joint ventures and associates was £1 million, or 25 per cent, lower at a profit of £3 million compared to a profit of £4 million in 2008.

On 16 January 2009, the Group acquired 100 per cent of the ordinary share capital of HBOS plc. The consideration for the acquisition of HBOS comprised the issue of 7,776 million ordinary shares in Lloyds Banking Group plc together with the costs of acquisition. In determining the fair value of the consideration, the Company used the share price of its equity securities quoted on the London Stock Exchange, as at the date of completion. As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill of £11,173 million arose on the acquisition. The negative goodwill is recognised as Gain on acquisition in the income statement for the year ended 31 December 2009.

The exercise to fair value the assets and liabilities of HBOS took into account prevailing market conditions at the time of completion and, where appropriate, the Group engaged independent external advisers. As the consideration paid was significantly less than the provisional fair value of the net assets acquired, the results of the fair value calculations were subject to additional challenge in accordance with the requirements of IFRS 3.

On the date that the acquisition was announced (18 September 2008) the implied goodwill was a small positive amount based on the share price of the Company and the originally announced conversion factor of 0.833 Lloyds Banking Group plc shares for each HBOS share. However, a number of factors led to negative goodwill being recognised on completion of the transaction. By the time of the recommended offer, it had become increasingly difficult for HBOS to raise funds in wholesale markets and HBOS faced an outflow of customer deposits, reflecting reduced investor and depositor confidence. Subsequent to the announcement of the offer, turbulence in the markets continued, fuelled by concerns about credit risk and worsening economic conditions. For HBOS, confidence continued to deteriorate amid ongoing funding difficulties and concerns over the extent of future credit losses. Measures by national authorities and central banks failed to stem this turbulence and the UK Government decided in October 2008 that it would be appropriate for the UK banking sector to increase its level of capitalisation. The capital raising, underwritten by the UK Government, was made available to HBOS on condition that the acquisition by the Company completed. As a consequence of the capital that HBOS was required to issue and the impact of market conditions on the future prospects of the new group, the terms of the final agreed offer were revised down to a ratio of 0.605. Additionally, the share price of the Company fell from 280p at the date of the announcement to 98.4p on 15 January 2009 reflecting both the dilutive impact of the capital that the Company raised and the turmoil in the banking sector and equity markets in general. These factors combined to reduce the value of the consideration for HBOS.

In 2009, the Group recorded a tax credit of £1,911 million compared to a tax credit of £38 million in 2008. The tax credit in 2009 on a profit before tax of £1,042 million reflects the fact that the gain on acquisition of £11,173 million is not taxable, partly offset by the impact of losses in joint ventures and associates, losses where no deferred tax is provided and the tax charge attributable to UK life insurance policyholders and the Group s interests in Open Ended Investment Companies (OEICs), which is required to be included within the income tax credit.

Total assets were £591,222 million higher at £1,027,255 million at 31 December 2009 compared to £436,033 million at 31 December 2008; loans and advances to customers were £386,625 million higher at £626,969 million at 31 December 2009 compared to £240,344 million at 31 December 2008; and customer deposits were £235,803 million higher at £406,741 million at 31 December 2009 compared to £170,938 million at 31 December 2008. These increases reflect the impact of the HBOS acquisition and, after allowing for the acquisition, total assets have reduced as the Group has commenced its announced strategy to reduce assets associated with non-relationship lending and investments, including business which is outside the Group s current risk appetite. During 2009, the Group identified approximately £300 billion of such assets; it is the Group s intention to manage these assets for value and, given the current economic climate, the primary focus will be on running these assets down over time. Over the next five years, the Group expects to achieve a reduction in these assets of approximately £200 billion (customer lending approximately £140 billion; treasury assets £60 billion). During 2009, this portfolio of assets reduced by some £60 billion. Subsequent to the HBOS acquisition, the Group s loans and advances to customers have decreased as a result of the alignment of heritage risk appetites in Retail, a reduction in wholesale lending in Corporate Markets and a reduction in Wealth and International; customer deposits also decreased as growth in Retail was offset by the planned reduction in higher interest paying term deposits elsewhere.

The Group s credit market exposures primarily relate to asset-backed securities exposures held in the Wholesale division; on the balance sheet these exposures are classified as loans and receivables, available-for-sale or trading and other financial assets at fair value through profit or loss depending on the nature of the investment. A detailed analysis of the Group s asset-backed security exposures is provided in note 54 to the consolidated financial statements on page F-110. The total exposure to asset-backed

securities has increased by £29,769 million from £16,521 million at 31 December 2008 to £46,290 million at 31 December 2009; however £31,010 million of these assets arise within the heritage HBOS business and, excluding these, total exposure to asset-backed securities was £1,241 million lower at £15,280 million at 31 December 2009 compared to £16,521 million at 31 December 2008.

Mortgage-backed security exposures were £11,817 million higher at £18,218 million, although excluding the heritage HBOS exposures they were £1,303 million lower at £5,098 million compared to £6,401 million at 31 December 2008. Exposures to Alt-A US residential mortgage-backed securities were £3,479 million higher, although adjusting for the heritage HBOS assets they were £167 million lower at £321 million compared to £488 million at 31 December 2008; there is no exposure to sub-prime US residential mortgage-backed securities.

For credit market exposures the Group s approach is to analyse the underlying transaction to determine whether it needs to place reliance on any protection provided by an insurer or guarantor. In note 54 to the consolidated financial statements on page F-111 the Group discloses its exposures where reliance is placed on monoline insurers, which are limited to a total of £444 million at 31 December 2009. Of this total exposure, £436 million is rated AA with the remaining £8 million being sub-investment grade.

At the end of December 2009, the Group s capital ratios, following the capital raising in December 2009, increased with a total capital ratio on a Basel II basis of 12.4 per cent (compared to 11.2 per cent at 31 December 2008), a tier 1 ratio of 9.6 per cent (compared to 8.0 per cent at 31 December 2008) and a core tier 1 ratio of 8.1 per cent (compared to 5.6 per cent at 31 December 2008). During 2009, risk-weighted assets increased by £322,817 million to £493,307 million compared to £170,490 million at 31 December 2008; this increase reflects the impact of the HBOS acquisition and, after allowing for the acquisition, there was a small decrease in risk-weighted assets as the effect of a reduction in balance sheet assets was partly offset by the procyclical impact of the weaker economic environment.

2008 COMPARED WITH 2007

The Group s profit before tax in 2008 was £3,239 million, or 81 per cent, lower at £760 million compared to £3,999 million in 2007. Profit attributable to equity shareholders was £2,516 million, or 77 per cent, lower at £772 million compared to £3,288 million in 2007. Earnings per share were 22.2p, or 77 per cent, lower at 6.7p compared to 28.9p in 2007.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

Other income was a net expense of £709 million compared with net income of £12,119 million in 2007. The decrease of £12,828 million principally resulted from a decrease of £12,309 million in net trading income, with smaller decreases in net fee and commission income, of £87 million, other operating income, of £414 million, and insurance premium income, of £18 million. The reduction in net trading income principally arose in the Group s insurance businesses and arose from the losses on policyholder investments; this decrease was broadly matched by a reduction in the insurance claims expense and on other lines within the income statement. Net trading income in Corporate Markets was also adversely affected by the impact of the continued market turmoil in 2008. Fees and commissions receivable were £7 million higher at £3,231 million compared to £3,224 million in 2007; increases in fees from corporate banking and card services were largely offset by a reduction in fees from insurance broking and as a result of disposals in 2007. Fees and commissions payable were £94 million, or 16 per cent, higher at £694 million compared to £600 million in 2007 as a result of increases in fees payable related to added-value account packages and cards, in both cases as a result of increased business volumes. Other operating income was £414 million, or 44 per cent, lower at £528 million compared with £942 million in 2007. The majority of this reduction resulted from the deterioration of the value of in-force asset in the insurance business.

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

Operating expenses were £532 million, or 10 per cent, higher at £6,100 million compared to £5,568 million in 2007. Operating expenses in 2008 included provisions in respect of certain historic US dollar payments and in respect of a Financial Services Compensation Scheme levy of £180 million and £122 million, respectively, and operating expenses in 2007 included £76 million in respect of the settlement of overdraft claims (see *Operating expenses* for more detail on these items). Staff costs were £73 million, or 3 per cent, higher at £2,978 million compared with £2,905 million in 2007. Salaries were £102 million higher at £2,230 million as the decrease in costs resulting from the sale of businesses in 2007 was more than offset by annual pay awards and an increased charge in respect of share-based compensation. Social security and pension and other post-retirement costs were broadly flat at £411 million in 2008 compared with £405 million in 2007. There was a decrease of £53 million in redundancy costs as the level of particular restructuring initiatives seen in 2007 was not repeated in 2008. Other staff costs were £18 million, or 6 per cent, higher at £323 million in 2008 as a result of a further increase in agency staff costs (used to cover project work). Excluding the provisions in respect of certain historic US dollar payments and in respect of the Financial Services Compensation Scheme levy in 2008 and the settlement of overdraft claims in 2007, other administrative expenses increased £77 million, or 4 per cent, to £2,034 million in 2008 from £1,957 million in 2007.

The impairment charge in the income statement was £1,216 million, or 68 per cent, higher at £3,012 million in 2008 compared with £1,796 million in 2007. The 2008 charge comprised a charge of £2,876 million, compared to £1,721 million in 2007, in respect of impairment losses on loans and receivables, a charge of £130 million, compared to £70 million in 2007, in respect of the impairment of available-for-sale financial assets and a charge of £6 million, compared to £5 million in 2007, relating to other credit risk provisions. In UK Retail Banking the charge increased by £248 million, or 20 per cent, to £1,472 million from £1,224 million in 2007; for personal loans and overdrafts the charge increased by £100 million and the charge in respect of mortgages increased by £149 million. The impairment charge as a percentage of average lending was higher at 1.22 per cent compared to 1.10 per cent in 2007. In Wholesale and International Banking the charge in respect of impairment losses on loans and receivables increased by £905 million, or 182 per cent, to £1,402 million from £497 million in 2007, reflecting the economic slowdown in the UK and the impact of a number of high profile financial services company collapses. Overall, the Group s charge in respect of impairment losses on loans and receivables expressed as a percentage of average lending increased to 1.24 per cent compared to 0.84 per

cent in 2007.

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2009	2008	2007
Net interest income £m	**9,026**	7,718	6,099
Average interest-earning assets £m	**849,534**	293,967	262,144
Average rates:			
Gross yield on interest-earning assets %[1]	**3.32**	5.98	6.44
Interest spread %[2]	**1.02**	2.37	2.20
Net interest margin %[3]	**1.06**	2.63	2.33
Margin excluding average balances held under reverse repurchase agreements[4]:			
Net interest income £m	**9,026**	7,718	6,099
Average interest-earning assets £m	**841,713**	282,400	248,233
Net interest margin %	**1.07**	2.73	2.46

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

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

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

4 Comparisons of net interest income and margins are impacted by the holdings of fine margin reverse repurchase agreements. To improve comparability, figures are also shown excluding average balances held under reverse repurchase agreements (2009: £7,821 million; 2008: £11,567 million; 2007: £13,911 million).

2009 COMPARED WITH 2008

Net interest income was £1,308 million, or 17 per cent, higher at £9,026 million in 2009 compared to £7,718 million in 2008. Excluding the net interest income of £4,049 million arising on the consolidation of HBOS s post-acquisition results, net interest income was £2,741 million, or 36 per cent, lower at £4,977 million in 2009 compared to £7,718 million in 2008.

Excluding the interest flows arising on the consolidation of HBOS s post-acquisition results, both interest income and interest expense fell in response to the historically low interest rate environment that prevailed throughout 2009; net interest income was reduced as the benefit of higher asset pricing was more than offset by the impact of lower deposit margins, reflecting the impact of falling base rates, and higher funding costs, which included the impact of the Group extending its wholesale funding maturity profile.

Average interest-earning assets were £555,567 million higher at £849,534 million in 2009 compared to £293,967 million in 2008. Excluding the average interest-earning assets of £526,630 million arising on the consolidation of HBOS s post-acquisition results, average interest-earning assets were £29,207 million, or 10 per cent, higher at £323,174 million in 2009 compared to £293,967 million in 2008.

Excluding the average interest-earning assets arising on the consolidation of HBOS s post-acquisition results, average personal mortgage balances within Retail were £5,973 million, or 6 per cent, higher at £106,068 million in 2009 compared to £100,095 million in 2008 as a result of the full-year effect on average balances of mortgage growth during 2008; period end mortgage balances being little changed over 2009. Average other personal lending balances within Retail were flat as the full-year effect on average balances of lending growth during 2008 has been offset by the impact of lower lending balances over 2009 as customers have reduced their personal indebtedness and not taken on new financial commitments in the current difficult economic environment. Average interest-earning assets in the Group s other businesses were £23,312 million, or 14 per cent, higher at £190,591 million in 2009 compared to £167,279 million in 2008 as the full year benefit of lending growth over 2008 more than offset the asset reductions in 2009.

The Group s net interest margin decreased by 157 basis points to 1.06 per cent in 2009 compared to 2.63 per cent in 2008 with reductions across the Group s businesses. Margins in Retail declined as the impact of higher wholesale funding costs and lower deposit margins, in the low base rate environment, was only partly offset by the benefit of higher pricing on lending products. In Wholesale margins were also reduced, again as higher wholesale funding costs were only partly offset by higher asset pricing. Declining margins in Wealth and International reflected reducing base rates, a very competitive deposit environment and the increased funding costs.

2008 COMPARED WITH 2007

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

OTHER INCOME

	2009	2008	2007
	£m	£m	£m
Fee and commission income:			
Current account fees	**1,088**	707	693
Insurance broking	**539**	549	648
Credit and debit card fees	**765**	581	536
Trust and other fiduciary fees	**395**	413	362
Other	**1,467**	981	985
	4,254	3,231	3,224
Fee and commission expense	**(1,517)**	(694)	(600)
Net fee and commission income	**2,737**	2,537	2,624
Net trading income	**19,098**	(9,186)	3,123
Insurance premium income	**8,946**	5,412	5,430
Gain on capital transactions	**1,498**		
Other operating income	**3,992**	528	942
Total other income	**36,271**	(709)	12,119

2009 COMPARED WITH 2008

Other income was £36,980 million higher at £36,271 million in 2009 compared to a deficit of £709 million in 2008, as a result of the factors discussed below.

Fee and commission income was £1,023 million, or 32 per cent, higher at £4,254 million in 2009 compared to £3,231 million in 2008. However, excluding the fee and commission income that arose on the consolidation of HBOS s post-acquisition results, fee and commission income was £479 million, or 15 per cent, lower at £2,752 million in 2009 compared to £3,231 million in 2008. The £479 million decrease in fee and commission income excluding the fee income in HBOS is largely due to a £424 million reduction in insurance broking income as a result of a market-wide move to monthly premiums on payment protection products, rather than up-front annual income.

Fee and commission expense was £823 million, or 119 per cent, higher at £1,517 million in 2009 compared to £694 million in 2008. Excluding fees payable of £862 million arising on the consolidation of the post-acquisition results of HBOS, fee and commission expense was £39 million, or 6 per cent, lower at £655 million in 2009 compared to £694 million in 2008 primarily as a result of volume-related reductions in asset management and other fees.

Net trading income improved by £28,284 million to net income of £19,098 million in 2009 compared to a net loss of £9,186 million in 2008. Excluding net trading income of £12,093 million arising from the consolidation of the post-acquisition results of HBOS, net trading income improved by £16,191 million to net income of £7,005 million in 2009 compared to a net loss of £9,186 million in 2008. Trading income in 2008 in the Group s banking operations was particularly impacted by market dislocation, leading to significant downwards valuations on a number of assets; this was not repeated in 2009. In addition there was an improvement of £14,179 million in gains on policyholder investments held in the Group s insurance businesses (and largely offset by an increase in the claims expense) as the improvement in market conditions has led to trading profits in 2009, compared to substantial losses in 2008.

Insurance premium income was £3,534 million, or 65 per cent, higher at £8,946 million in 2009 compared to £5,412 million in 2008. Excluding the premium income of £4,718 million that arose on consolidation of the post-acquisition results of HBOS, insurance premium income was £1,184 million, or 22 per cent, lower at £4,228 million in 2009 compared to £5,412 million in 2008. Earned premiums in respect of the Group s long-term life and pensions business were £2,660 million, or 55 per cent, higher at £7,460 million in 2009 compared to £4,800 million in 2008. The consolidation of the post-acquisition results of HBOS contributed £3,890 million and, excluding this, premiums were £1,230 million, or 26 per cent, lower at £3,570 million in 2009 compared to £4,800 million in 2008; this reflects reduced new business sales as a result of the general contraction in the UK market. General insurance earned premiums were £874 million higher at £1,486 million in 2009 compared to £612 million in 2008. Excluding premiums of £828 million arising from the consolidation of the post-acquisition results of HBOS, general insurance earned premiums were £46 million, or 8 per cent, higher at £658 million in 2009 compared to £612 million in 2008; this primarily reflects modest growth in home insurance income.

During 2009 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liability of £1,498 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs; this gain arose because the balance sheet carrying values of these investments were in excess of market valuations at the time. In the first half of 2009, undated subordinated notes issued by a number of Group companies were exchanged for innovative tier 1 securities and senior unsecured notes issued by Lloyds TSB Bank plc. These exchanges resulted in a gain of £745 million. In July 2009, dated and undated subordinated liabilities issued by Clerical Medical Finance plc were exchanged for senior unsecured notes issued by Lloyds TSB Bank plc resulting in a gain of £30 million. In November 2009, as part of the restructuring plan that was a requirement for

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EC approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group s preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. This suspension gave rise to a partial extinguishment of the original liability, equivalent to the present value of the suspended cash flows. During December 2009, as part of the Group s recapitalisation and exit from the Government Asset Protection Scheme, certain preference shares, preferred securities and undated subordinated notes were exchanged for enhanced capital notes. These exchanges, together with the partial extinguishment of liabilities arising from the suspension of payments on coupons, resulted in a gain of £723 million.

Other operating income was £3,464 million higher at £3,992 million in 2009 compared to £528 million in 2008; excluding the income of £1,517 million that arose on the consolidation of the post-acquisition results of HBOS, other operating income was £1,947 million higher at £2,475 million in 2009 compared to £528 million in 2008, principally reflecting an improvement in the movement in value of in-force business.

2008 COMPARED WITH 2007

Other income was £12,828 million lower at a net deficit of £709 million in 2008 compared to income of £12,119 million in 2007.

Fee and commission income was £7 million higher at £3,231 million in 2008 compared to £3,224 million in 2007. UK current account fees were £14 million higher reflecting growth in the numbers of higher-fee earning accounts during 2008. Insurance broking income was £99 million lower, driven by a sharp decrease in creditor insurance income as a side-effect of the reduced availability of consumer credit. Card fees were £45 million higher; merchant service charges were higher due to continuing growth in the merchant base and interchange income was £25 million higher as a result of increased levels of card usage. Other fees and commissions were £4 million lower at £981 million; continuing increases in factoring fees, corporate banking fees and asset management fees (in part due to the contracts entered into for the ongoing management of Abbey Life funds subsequent to disposal of that business in 2007) were offset by reductions in fees following the sale of Lloyds TSB Registrars and other businesses in 2007.

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

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

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

Other operating income was £414 million, or 44 per cent, lower at £528 million compared to £942 million in 2007. The movement in value of in-force business was a reduction of £325 million compared to a reduction of £93 million in 2007, as an improvement in new business income was more than offset by lower income from existing business principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets. There was a reduction of £1 million in operating lease rental income and a reduction of £49 million in car dealership income following the sale of the Dutton Forshaw business in 2007 as well as reductions in other non-fee income.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OPERATING EXPENSES

	2009 £m	2008[1] £m	2007[1] £m
Administrative expenses:			
Staff:			
Salaries	**4,369**	2,230	2,128
Social security costs	**383**	176	167
Pensions and other post-retirement benefit schemes	**744**	235	238
Restructuring costs	**412**	14	67
Other staff costs	**767**	323	305
	6,675	2,978	2,905
Premises and equipment:			
Rent and rates	**569**	318	304
Hire of equipment	**20**	16	16
Repairs and maintenance	**226**	151	154
Other	**341**	165	145
	1,156	650	619
Other expenses:			
Communications and data processing	**668**	455	462
Advertising and promotion	**335**	194	192
Professional fees	**540**	229	279
Other	**1,310**	808	481
	2,853	1,686	1,414
Depreciation and amortisation:			
Depreciation of tangible fixed assets	**1,716**	648	594
Amortisation of acquired in-force non-participating investment contracts	**75**		
Amortisation of other intangible assets	**769**	38	36
	2,560	686	630
Impairment of goodwill	**240**	100	
Total operating expenses, excluding Government Asset Protection Scheme fee	**13,484**	6,100	5,568
Government Asset Protection Scheme fee	**2,500**		
Total operating expenses	**15,984**	6,100	5,568
Cost: income ratio (%)[2]	**68.7**	61.8	52.1

1 Restated for IFRS 2 (Revised).

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

2009 COMPARED WITH 2008

Operating expenses increased by £9,884 million, or 162 per cent, to £15,984 million in 2009 compared to £6,100 million in 2008. Excluding the operating expenses of £6,456 million arising on the consolidation of HBOS s post-acquisition results, operating expenses were £3,428 million, or 56 per cent, higher at £9,528 million in 2009 compared to £6,100 million in 2008; this increase principally reflects the £2,500 million fee paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme, costs of £635 million borne within the Lloyds TSB businesses in respect of the integration of the enlarged Group and an increased charge in respect of goodwill impairment, only partly offset by the fact that operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments which was not repeated in 2009.

Staff costs were £3,697 million, or 124 per cent, higher at £6,675 million compared to £2,978 million in 2008. Excluding the staff costs of £3,014 million that arose on consolidation of the post-acquisition results of HBOS, staff costs were £683 million, or 23 per cent, higher at £3,661 million in 2009 compared to £2,978 million in 2008. Excluding the costs within HBOS, salaries were £87 million, or 4 per cent, higher as the impact of annual pay rises has more than offset staff reductions; pension costs were £128 million higher principally as a result of reduced asset levels in the defined benefit schemes at the end of 2008 which led to a lower expected return; restructuring costs were £209 million higher principally as a result of staff rationalisation as part of the Group integration programme; and other staff costs were £241 million higher, partly reflecting increased use of agency staff in relation to

the integration programme.

Premises and equipment costs were £506 million, or 78 per cent, higher at £1,156 million in 2009 compared to £650 million in 2008. Excluding the premises and equipment costs that arose on the consolidation of the post-acquisition results of HBOS, premises and equipment costs were £84 million, or 13 per cent, higher at £734 million in 2009 compared to £650 million in 2008; rent and rates were £30 million higher, largely as a result of rent reviews, repairs and maintenance were £24 million higher and other premises and equipment costs were £36 million higher.

Other expenses were £1,167 million, or 69 per cent, higher at £2,853 million in 2009 compared to £1,686 million in 2008. Excluding the £1,185 million of costs that arose on consolidation of the post-acquisition results of HBOS, other costs were £18 million, or 1 per cent, lower at £1,668 million in 2009 compared to £1,686 million in 2008; however operating expenses in 2008 included the £180 million settlement in relation to certain historic US dollar payments and, excluding this, operating expenses excluding HBOS in 2009 were £162 million, or 11 per cent, higher at £1,668 million compared to £1,506 million in 2008. On this basis, professional fees were higher as a result of consultancy and other costs incurred in relation to integration, the Group s consideration of the Government Asset Protection Scheme and other strategic projects; there were also increases in communications and data processing costs.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Depreciation and amortisation costs were £1,874 million higher at £2,560 million compared to £686 million in 2008. Depreciation of tangible fixed assets was £1,068 million higher at £1,716 million compared to £648 million in 2008; £1,035 million of this increase reflects the impact of consolidation of the post-acquisition results of HBOS. Amortisation of £75 million in respect of the acquired value of in-force non-participating investment contracts and £703 million in respect of acquisition-related intangibles (brands, core deposit intangibles, purchased credit card relationships and other customer related intangibles) arose from the acquisition of HBOS.

A charge of £240 million (2008: £100 million) arose in respect of the impairment of goodwill. The Group reviews goodwill held on its balance sheet for impairment at least annually or when events or changes in economic circumstances indicate that an impairment may have taken place. Goodwill attributable to the Group s Asset Finance business, for which an impairment charge of £100 million was recognised in the Group s financial statements for the year ended 31 December 2008, has been further reviewed for impairment due to the continuing uncertainties over the short-term macroeconomic environment. As a consequence, the carrying value of the consumer finance cash generating unit in Asset Finance (within Wholesale division) has been reassessed resulting in an additional goodwill impairment charge of £240 million in the year ended 31 December 2009.

The Group also paid a fee of £2,500 million to the UK Government in respect of the Group s withdrawal from the Government Asset Protection Scheme (GAPS). The Group had entered into a Pre-Accession Deed dated 7 March 2009 relating to the proposed participation in GAPS. However, following the rights issue in November 2009, the Group withdrew from its proposed participation and, on 3 November 2009, entered into a GAPS Withdrawal Deed with HM Treasury pursuant to which, among other matters, the Group agreed to pay HM Treasury an amount of £2,500 million in recognition of the benefits to the Group s trading operations arising as a result of HM Treasury proposing to make GAPS available to the Group.

2008 COMPARED WITH 2007

Operating expenses were £532 million, or 10 per cent, higher at £6,100 million in 2008 compared to £5,568 million in 2007. Operating expenses in both 2008 and 2007 were, however, impacted by a number of individually significant items. In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney s Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices; the Group had provided £180 million in respect of this matter in its 2008 results. The arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit taking institutions involving the Financial Services Compensation Scheme (FSCS) will result in a significant increase in the levies made by the FSCS on the industry. The Group made a provision of £122 million in 2008 in respect of its obligation for the estimated interest cost on the FSCS borrowings. During 2008, the basis of goodwill allocation in parts of the Asset Finance business was changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance. The markets in which this unit operated had been affected by the UK economic downturn, which was characterised by falling demand and increasing arrears at that point of that cycle. This, together with uncertainties over the likely short-term macroeconomic environment, resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million in 2008. The 2007 results included a charge of £76 million relating to the settlement of overdraft claims during that year, together with related costs. If the provision in respect of certain historic US dollar payments, the provision for the Financial Services Compensation Scheme levy and the impairment of goodwill in 2008 and the settlement of overdraft claims in 2007, are excluded, underlying operating expenses were £206 million, or 4 per cent, higher at £5,698 million in 2008 compared to £5,492 million in 2007, for the following reasons.

Staff costs were £73 million, or 3 per cent, higher at £2,978 million in 2008 compared to £2,905 million in 2007. Salaries were £102 million, or 5 per cent, higher at £2,230 million. There was a small increase in staff numbers which, together with the effect of the annual pay awards and an increased charge in respect of share-based compensation, more than offset staff reductions following the sale of businesses during 2007. National insurance costs were £9 million, or 5 per cent, higher at £176 million compared to £167 million in 2007. Pension costs were £3 million, or 1 per cent, lower at £235 million compared to £238 million in 2007; this small reduction arose because an £8 million increase in the cost of contributions to defined contribution pension schemes (which cover all eligible new employees) has been more than offset by an £11 million reduction in the charge in respect of defined benefit schemes (following further increases in asset values and expected returns at the end of 2007). There was a £53 million decrease in redundancy costs as the level of particular restructuring initiatives seen in 2007 was not repeated in 2008. Other staff costs were £18 million, or 6 per cent, higher at £323 million compared to £305 million in 2007 as a result of a further increase in costs for agency staff (used to cover project work).

Premises and equipment costs were £31 million, or 5 per cent, higher at £650 million in 2008 compared to £619 million in 2007. Rent and rates were £14 million higher, as a result of rent reviews and some new properties taken on. Hire of equipment was unchanged at £16 million and repairs and maintenance costs were £3 million lower at £151 million. Other premises and equipment costs were £20 million higher at £165 million, compared to £145 million in 2007, following an increase in losses on disposal of

equipment due to the downturn in the used car market and a lower level of profits on disposal of premises as the number of particular transactions in 2007 was not repeated in 2008; there were also increases in premises management charges.

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

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

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

The cost: income ratio was 61.8 per cent in 2008 compared to 52.1 per cent in 2007.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

	2009	2008	2007
	£m	£m	£m
Impairment losses on loans and receivables:			
Loans and advances to banks	**(3)**	135	(1)
Loans and advances to customers	**15,783**	2,584	1,722
Debt securities classified as loans and receivables	**248**	157	
Total impairment losses on loans and receivables	**16,028**	2,876	1,721
Impairment of available-for-sale financial assets	**602**	130	70
Other credit risk provisions	**43**	6	5
Total impairment charged to the income statement	**16,673**	3,012	1,796

2009 COMPARED WITH 2008

Impairment losses increased by £13,661 million to £16,673 million in 2009 compared to £3,012 million in 2008. Excluding the impairment losses of £12,257 million arising on the consolidation of HBOS s post-acquisition results, impairment losses were £1,404 million, or 47 per cent, higher at £4,416 million in 2009 compared to a £3,012 million in 2008; this increase includes £1,664 million in respect of loans and advances to customers and reflects the substantial deterioration in the credit environment; partly offset by a reduction in the charge in respect of loans and advances to banks and other impairment provisions.

The impairment charge in respect of loans and advances to customers was £13,199 million higher at £15,783 million in 2009 compared to £2,584 million in 2008. Excluding the impairment losses of £11,535 million arising on the consolidation of HBOS s post-acquisition results, impairment losses in respect of loans and advances to customers were £1,664 million, or 64 per cent, higher at £4,248 million in 2009 compared to £2,584 million in 2008. This reflects the substantial deterioration in the credit environment leading to increased charges in respect of both unsecured personal lending, as rising UK unemployment has impacted the charge in both the retail banking and asset finance operations, and non-personal lending. During 2009, following the acquisition of HBOS, the Group has experienced a significant rise in impairment levels in its lending portfolios. This largely represents falls in the value of commercial real estate and the impact of the economic deterioration during the year, including the effects of rising unemployment and reduced corporate cash flows. In Retail, impairment losses increased, particularly reflecting the impact of increases in UK unemployment during 2009 on the unsecured charge, which was partly offset by a lower secured impairment charge as house prices stabilised. The Wholesale charge increased significantly reflecting the year-on-year decline in commercial property valuations and reduced levels of corporate cash flows; in particular, the real estate related lending exposures in the heritage HBOS portfolios were more sensitive to the downturn in the economic environment. The Group has spent a significant amount of time analysing and addressing the issues in the heritage HBOS portfolios, with the greatest attention paid to the over concentration in real estate related lending and those portfolios that fall outside of the Lloyds TSB risk appetite. As a result of this portfolio review, which applied prudent assumptions to real estate asset expectations, and with the deterioration in the economy translating into lower commercial property valuations, the Group took prudent and material impairment charges in the period following the acquisition. In the Wealth and International business the impairment charge reflected significant provisions against the Irish and Australian commercial real estate portfolios.

The impairment charge in respect of loans and advances to banks improved by £138 million to a credit of £3 million compared to a charge of £135 million in 2008; this reflected a small release in 2009 whereas 2008 included a number of specific charges as a result of the economic conditions faced by some banks at that time.

The impairment charge in respect of debt securities classified as loans and receivables increased by £91 million, or 58 per cent, to £248 million in 2009 compared to £157 million in 2008; £140 million arose from the consolidation of the post-acquisition results of HBOS and there was a reduction of £49 million in respect of heritage Lloyds TSB businesses.

Impairment losses in respect of available-for-sale financial assets were £472 million higher at £602 million in 2009 compared to £130 million in 2008. This increase was principally due to the charge of £577 million arising on the consolidation of the post-acquisition results of HBOS and reflects impairment of certain debt securities taken on as part of the acquisition.

The charge in respect of other credit risk provisions was £43 million in 2009 compared to £6 million in 2008; £5 million of the charge in 2009 relates to the post-acquisition results of HBOS.

2008 COMPARED WITH 2007

The impairment charge in the income statement was £1,216 million, or 68 per cent, higher at £3,012 million in 2008 compared to £1,796 million in 2007. This comprised a charge of £2,876 million, compared to a charge of £1,721 million in 2007, in respect of impairment losses on loans and receivables, a charge of £130 million, compared to a charge of £70 million in 2007, in respect of the impairment of available-for-sale financial assets and a charge of £6 million, compared to a charge of £5 million in 2007, in respect of other credit risk provisions.

The impairment charge in respect of loans and receivables was £1,155 million, or 67 per cent, higher at £2,876 million compared to £1,721 million in 2007.

In UK Retail Banking the charge increased by £248 million, or 20 per cent, to £1,472 million from £1,224 million in 2007, resulting in a charge as a percentage of average lending of 1.22 per cent compared to 1.10 per cent in 2007. This particularly reflected an increase of £149 million in the impairment charge in respect of mortgage lending from £18 million in 2007 to £167 million in 2008 as a result of the impact of reducing house prices and a deterioratiing economic environment in the UK. Increased impairment charges also arose in respect of personal loans and overdrafts (up £100 million, or 15 per cent, from £679 million in 2007 to £779 million in 2008) as a result of higher arrears, resulting in an increase in the impairment charge, expressed as a percentage of average lending, from 5.32 per cent in 2007 to 5.73 per cent in 2008. The impairment charge in respect of credit card outstandings was flat at £526 million in 2008 compared to £527 million in 2007, despite a decrease in average balances, as a result of increased arrears and fraud losses the impairment charge in respect of card lending, expressed as a percentage of average lending, increased from 7.96 per cent in 2007 to 8.12 per cent in 2008.

A charge of £2 million, compared to £nil in 2007, in Insurance and Investments related to the mortgage lending in Scottish Widows Bank.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

In Wholesale and International Banking the impairment charge in respect of loans and receivables increased by £905 million from £497 million in 2007 to £1,402 million in 2008 and this charge as a percentage of average lending was 1.33 per cent compared to 0.57 per cent in 2007. The charge within Corporate Markets was significantly higher at £939 million in 2008 compared to £165 million in 2007 as a result of a charge of £253 million, compared to a charge of £22 million in 2007, in relation to exposures to assets affected by current capital markets uncertainties, as well as a number of charges in relation to customers affected by the severe economic downturn and to the collapse of certain financial services companies. The impairment charge in Commercial Banking was £89 million, or 90 per cent, higher at £188 million in 2008 compared to £99 million in 2007, again reflecting the impact of the economic downturn; and the charge in Asset Finance was £42 million, or 18 per cent, higher at £270 million in 2008 compared to £228 million in 2007, as a result of higher arrears.

Overall, the Group s charge in respect of impairment losses on loans and receivables expressed as a percentage of average lending increased to 1.24 per cent compared to 0.84 per cent in 2007.

A charge of £130 million in 2008, compared to a charge of £70 million in 2007, arose in respect of the impairment of available-for-sale financial assets, largely in relation to certain asset-backed security collateralised debt obligations, although £30 million of the charge in 2008 reflected the write-off of the Group s investment in Bradford & Bingley equity shares.

TAXATION

	2009 **£m**	2008 £m	2007 £m
UK corporation tax:			
Current tax on profits for the year	**(227)**	(667)	(763)
Adjustments in respect of prior years	**(310)**	(19)	30
	(537)	(686)	(733)
Double taxation relief	**10**	91	60
	(527)	(595)	(673)
Foreign tax:			
Current tax on profits for the year	**(221)**	(144)	(98)
Adjustments in respect of prior years	**40**	4	3
	(181)	(140)	(95)
Current tax charge	**(708)**	(735)	(768)
Deferred tax	**2,619**	773	89
Taxation credit (charge)	**1,911**	38	(679)

2009 COMPARED WITH 2008

The rate of tax is influenced by the geographic and business mix of profits. The effective rate of tax was negative in both 2009 and 2008 as tax credits arose on the profits in both years; the statutory corporation tax rates were 28 per cent in 2009 and 28.5 per cent in 2008. The tax credit is distorted, in particular, by both the gain on acquisition of £11,173 million in 2009, which does not attract a tax charge, and the goodwill impairment charges of £240 million in 2009 and £100 million in 2008 on which no tax relief can be taken. The effective tax rate is also distorted by the requirement to include, within income tax in the income statement, the tax attributable to UK life insurance policyholder earnings and the Group s interests in OEICs, being a tax charge of £410 million for 2009 compared to a tax credit of £461 million in 2008. Excluding these items the effective tax rate in 2009 was 22.5 per cent compared to 32.0 per cent in 2008. Of this 9.5 per cent decrease in the effective rate, 7.3 per cent is attributable to the impact in 2009 of losses arising in certain subsidiaries resident in Ireland, for which a deferred tax asset cannot be recognised, and the statutory tax rate is 12.5 per cent; the remainder of the decrease in the effective tax rate in 2009 on this adjusted basis reflects normal fluctuations in disallowed and non-taxable items. The Group does not expect the tax rate, excluding the impact of policyholders tax and OEICs, to vary significantly from the average UK corporation tax rate.

2008 COMPARED WITH 2007

The effective rate of tax in 2008 was a negative 4.7 per cent, as a tax credit arose on the profit for the year, compared to an effective rate of tax in 2007 of 17.0 per cent and corporation tax rates of 28.5 per cent in 2008 and 30 per cent in 2007. The effective tax rate is distorted by the requirement to include, within income tax in the income statement, the tax attributable to UK life insurance policyholder earnings and the Group s interests in OEICs, being a tax credit of £461 million for 2008 compared to a tax credit of £217 million in 2007. The effective rate in 2007 was also particularly distorted by substantial profits on disposal of businesses, on which no tax charge arose, and the impact on the tax charge of the 2007 Finance Act reduction in the corporation

tax rate from 30 per cent to 28 per cent (as a result of which the Group s deferred tax liabilities were remeasured leading to a credit to the Group s tax charge of £110 million). Excluding these items the effective tax rate in 2008 was 32.0 per cent compared to 28.3 per cent in 2007. Of this 3.7 per cent increase in the effective rate, 3.9 per cent is attributable to the impact of the Group s £180 million provision in respect of certain historic US dollar payments, on which no tax relief is assumed; the remainder of the increase in the effective tax rate in 2008 on this adjusted basis reflected normal fluctuations in disallowed and non-taxable items.

ECONOMIC PROFIT

In pursuit of its aim to maximise shareholder value over time, the Group has for a number of years used a system of value based management as a framework to identify and measure value creation and has used economic profit, a non-GAAP measure, as a measure of performance. The Group continues to believe that economic profit provides important information for investors, because it captures both growth in investment and return and informs management decision making. In light of the substantial changes to the structure of the Group arising from the acquisition of HBOS and the changes in the quantum and structure of the Group s capital over 2009, the Group is in the process of determining appropriate economic profit methodologies for the enlarged group.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INTEGRATION

Annualised cost savings from synergies and other operating efficiencies of £2 billion are now targeted by the end of 2011, an increase from the previously forecast cost savings in excess of £1.5 billion. The increase arises in the main from further efficiency gains leading to role reductions and, to a lesser extent, property and procurement benefits which are now more certain following the application of the Lloyds TSB approach to HBOS.

Total cost reductions from synergies of £534 million are ahead of the target £450 million. They are analysed by division in the table below and relate primarily to reductions in staff numbers and procurement savings.

Integration costs of £1,096 million relating to severance, IT and business costs of implementation were incurred during 2009. The severance provisions are for over 15,000 role reductions announced in the year, of which more than 11,500 relate to 2009, the balance being delivered in 2010. The overwhelming majority of role reductions in 2009 were achieved through redeployment, natural turnover and voluntary redundancy.

The Group s policy is to use natural turnover and to redeploy people wherever possible to retain their expertise and knowledge within the Group. Where it is necessary for colleagues to leave the Group, this is achieved by offering voluntary severance and by making less use of contractors and agency colleagues. Compulsory redundancies are a last resort.

Savings realised year to 31 December 2009	**£m**		**£m**
By division		**By expenditure type**	
Retail	**124**	People	**263**
Wholesale	**86**	Procurement[1]	**126**
Wealth and International	**28**	IT	**57**
Insurance	**55**	Property	**11**
Group Operations	**221**	Other	**77**
Central items	**20**		
	534		**534**

[1] Procurement benefits totalling £174 million were achieved, split £126 million against the ongoing cost base and £48 million within the £1,096 million integration costs.

Over the last year, the Group has mobilised its integration programme, building systems integration plans whilst delivering financial benefits and making good progress towards creating a truly integrated organisation. For example, the Group has published proposals to harmonise employee terms and conditions across the Group, launched a single Group Intranet to improve communication and ease contact between colleagues and enhanced the IT infrastructure to allow colleagues full connectivity at the Group s buildings. A single consistent framework of risk policies is in place, comprising 71 detailed risk policies applicable across the combined Group.

Savings to date have been driven largely from role reductions resulting from deployment of the new Group organisational design adopting the Lloyds TSB approach. The overwhelming majority of role reductions in 2009 were achieved through redeployment, natural turnover and voluntary redundancy. Only a small proportion left via compulsory redundancy. In addition the Group has ceased occupancy of 83 properties during 2009, well ahead of the start of year target of 50.

Procurement benefits in 2009 have also been significant at £174 million with approximately £1.5 billion of spend having gone through e-auctions and the Group has in parallel reviewed and consolidated key supplier contracts with over 90 per cent of spend now being through its top 1,000 suppliers.

The Group has progressed well through the IT design and is now focused on building and delivering an integrated technical infrastructure. Preparations for system integration and data migration are in full flight with the scale up of IT equipment to handle increased volumes. Detailed plans are in place, along with testing requirements that are fully commensurate with an integration of this scale.

In the circular to shareholders regarding the acquisition of HBOS, it was stated that annual cost savings of £1.5 billion (run-rate) were expected to be achieved by the end of 2011 at a cost of approximately 140 per cent. The Group is now expecting £2 billion of

savings, analysed by division in the table below, at an implementation cost to synergy ratio of around 155 per cent. The increase in the ratio of implementation costs to annualised cost savings has been driven principally by a recognition of the relative complexity of the HBOS systems and processes.

The synergies achieved in the year of £534 million include a number of one-off savings, which have been excluded from the sustainable run-rate benefits. There has also been an increase in the rate of savings in the year resulting in a sustainable run-rate benefit of £766 million.

	2009		2011	
	Synergy run-rate £m	Current view of synergy targets £m	Allocation of Group Operations target to divisions £m	Current view by market facing division £m
Retail	157	378	489	867
Wholesale	157	282	250	532
Wealth and International	115	213	29	242
Insurance	99	162	77	239
Group Operations	209	907	(907)	
Central items	29	58	62	120
	766	2,000		2,000

This discussion of integration includes certain forward looking statements with respect to management s expectations for the Group s financial condition and performance, which by their nature involve risk and uncertainty. See *Forward looking statements* and *Risk factors* for a discussion of factors that could cause actual results to differ materially from the expectations expressed in such forward looking statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LINE OF BUSINESS INFORMATION

2009 COMPARED WITH 2008

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

The Group Executive Committee (GEC) has been determined to be the chief operating decision maker for the Group. The Group s operating segments reflect its organisational and management structures. GEC reviews the Group s internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment s net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

The Group s activities in 2009 were organised into four financial reporting segments: Retail, Wholesale, Wealth and International and Insurance. The segmental results and comparatives are presented on the basis reviewed by the chief operating decision maker and as a consequence include the pre-acquisition results of HBOS for 2008 and the period from 1 January 2009 to 16 January 2009.

Comparisons of results on a historical consolidated statutory basis are dominated by the impact of the acquisition of HBOS as the 2009 statutory results include the results of HBOS from 16 January 2009, together with the effects of the unwind of fair value adjustments made to the HBOS balance sheet on acquisition, and the 2008 statutory results do not include any results of HBOS. In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described below.

- In order to reflect the impact of the acquisition, the following adjustments have been made:
  - the 2008 results include the results of HBOS as if it had been acquired on 1 January 2008;
  - the 2009 results assume HBOS had been owned throughout the year;
  - the unwind of acquisition-related fair value adjustments is shown as one line in the 2009 combined businesses income statement and has not been back-dated to 2008; and
  - the gain on acquisition of HBOS and amortisation of purchased intangible assets have been excluded.
- In order to present better the underlying business performance the following items, not related to the acquisition, have also been excluded:
  - the results of BankWest and St. Andrews, sold in December 2008, and the related loss on disposal;
  - insurance and policyholder interests volatility;
  - integration costs;
  - goodwill impairment; and
  - Government Asset Protection Scheme fee.

Readers should be aware that the combined businesses basis has been presented for comparative purposes only and is not intended to provide proforma information or show the results of the Group if the acquisition of HBOS had taken place at an earlier date. Readers should also note that HBOS was not managed by the current management of Lloyds Banking Group in 2008.

The results of the businesses are set out below:

	2009	2008
	£m	£m
Retail	**1,382**	2,542
Wholesale	**(4,703)**	(10,479)
Wealth and International	**(2,356)**	277
Insurance	**975**	1,540
Group Operations and Central items:		
Group Operations	**(149)**	(76)
Central items	**(1,449)**	(517)
	(1,598)	(593)
Loss before tax combined businesses	**(6,300)**	(6,713)

The aggregate total of the combined businesses basis segmental results is a non-GAAP measure; further discussion of this measure is set out on page 39.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RECONCILIATION OF COMBINED BUSINESSES LOSS BEFORE TAX TO STATUTORY PROFIT BEFORE TAX FOR THE YEAR

	Note	**2009 £m**	2008 £m
Loss before tax combined businesses		**(6,300)**	(6,713)
Integration costs	1	**(1,096)**	
Volatility	2	**478**	(2,349)
Government Asset Protection Scheme fee	3	**(2,500)**	
Negative goodwill credit	4	**11,173**	
Amortisation of purchased intangibles and goodwill impairment	5	**(993)**	(258)
Pre-acquisition results of HBOS plc	6	**280**	10,825
Insurance grossing adjustment	7		10
Results of BankWest and St. Andrews	8		90
Loss on disposal of businesses	9		(845)
Profit before tax statutory		**1,042**	760

1. Integration costs

One-off integration costs of £1,096 million were incurred in 2009; these relate to severance, IT and other costs of implementation. The severance provisions relate to over 15,000 role reductions announced in 2009, of which more than 11,500 relate to 2009, the balance being delivered in 2010. The overwhelming majority of role reductions in 2009 were achieved through re-deployment, natural turnover and voluntary redundancy.

2. Volatility

The Group s statutory profit before tax is significantly affected by two items that impact the underlying financial performance of the Group, namely insurance volatility, caused by movements in financial markets, and policyholder interests volatility, which reflects primarily the gross up of policyholder tax included in the Group tax charge.
During 2009, the Group s statutory profit before tax included positive insurance and policyholder interests volatility of £478 million compared to negative volatility of £2,349 million in 2008 primarily reflecting the more favourable financial markets in 2009.

Volatility comprises the following:

	2009 £m	2008 £m
Insurance volatility	**237**	(1,425)
Policyholder interests volatility	**298**	(924)
Group hedge costs	**(57)**	
Total	**478**	(2,349)

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

The most significant limitations associated with profit before tax excluding volatility are:

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

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

Management compensates for the limitations above by:

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

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

Insurance volatility

The Group s insurance businesses have liability products that are supported by substantial holdings of investments, including equities, property and fixed interest investments, all of which are subject to variations in their value. The value of the liabilities does not move exactly in line with changes in the value of the investments, yet IFRS requires that the changes in the value of both the liabilities and the investments be reflected within the income statement. As these investments are substantial and movements in their value can have a significant impact on the profitability of the Group, management believes that it is appropriate to disclose the results on the basis of an expected return in addition to results based on the actual return.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

United Kingdom (Sterling)	**2010** %	**2009** %	2008 %
Gilt yields (gross)	**4.45**	**3.74**	4.55
Equity returns (gross)	**7.45**	**6.74**	7.55
Dividend yield	**3.00**	**3.00**	3.00
Property return (gross)	**7.45**	**6.74**	7.55
Corporate bonds in unit linked and with-profit funds (gross)	**5.05**	**4.34**	5.15
Fixed interest investments backing annuity liabilities (gross)	**5.30**	**5.72**	5.52

The impact on the results due to the actual return on these investments differing from the expected return (based upon economic assumptions made at the beginning of the year) is included within insurance volatility. Changes in market variables also affect the realistic valuation of the guarantees and options embedded within the With Profits Funds, the value of the in-force business and the value of shareholders funds.

The liabilities in respect of the Group s annuity business are matched by a portfolio of fixed interest securities, which includes a large proportion of corporate bonds. In accordance with the approach adopted in 2008, the value of in-force business for the annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of these corporate bond holdings. The illiquidity premium is estimated to have reduced to 75 basis points as at 31 December 2009 (31 December 2008: 154 basis points) which has offset the gains on assets backing the annuity liabilities reducing the volatility of the results. Overall, the positive volatility in 2009 of £237 million, reflected a partial recovery in financial markets. During 2009, equities have recovered by 22 per cent and corporate bond spreads have narrowed, offset by a reduction in gilts reflecting an increase in yields and a reduction in property values of 6.6 per cent. This contrasts with 2008 where a 33 per cent reduction in equities was the main driver of the £1,425 million negative volatility in 2008.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life and pensions business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, equalisation adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders over the long term.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group s tax charge rather than being offset against the related income. The impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Over the longer term the charges levied to policyholders to cover policyholder tax on investment returns and the related tax provisions are expected to offset. In practice timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility. Other sources of volatility include the minorities share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.

During the year ended 31 December 2009, the statutory profit before tax in both the Insurance and Wealth and International divisions included credits to other income which relate to the policyholder interests volatility credit of £298 million (2008: policyholder interests volatility charge of £924 million). The market recovery in 2009 increased policyholder tax liabilities and led to a policyholder tax charge of £346 million during the year in the Group s tax charge. This was partly offset by a credit of £48 million relating to differences in the expected levels of policyholder tax provisions and charges. This compares to 2008 when substantial policyholder tax losses were generated as a result of the fall in property, bond and equity values.

Hedge costs

To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of business in force on the Group balance sheet, the Group purchased put option contracts. The charge booked for 2009 was £57 million. These options expired on 15 January 2010.

3. Government Asset Protection Scheme fee

The Group entered into an agreement in March 2009 relating to its proposed participation in the Government Asset Protection Scheme (GAPS). However, following its successful rights issue, the Group withdrew from its proposed participation and agreed to pay HM Treasury £2,500 million in recognition of the benefits to the Group s trading operations arising as a result of HM Treasury proposing to make GAPS available to the Group (see *Major shareholders and related party transactions Information about the Lloyds Banking Group s relationship with the UK Government GAPS withdrawal deed*).

4. Negative goodwill credit

On 16 January 2009, the Group acquired 100 per cent of the ordinary share capital of HBOS plc. The consideration for the acquisition of HBOS comprised the issue of 7,776 million ordinary shares in Lloyds Banking Group plc together with the costs of acquisition. In determining the fair value of the consideration, the Company used the share price of its equity securities quoted on the London Stock Exchange, as at the date of completion.

As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill of £11,173 million arose on the acquisition. The negative goodwill is recognised as Gain on acquisition in the income statement for the year ended 31 December 2009.

The exercise to fair value the assets and liabilities of HBOS took into account prevailing market conditions at the time of completion and, where appropriate, the Group engaged independent external advisers. As the consideration paid was significantly less than the provisional fair value of the net assets acquired, the results of the fair value calculations were subject to additional challenge in accordance with the requirements of IFRS 3.

On the date that the acquisition was announced (18 September 2008) the implied goodwill was a small positive amount based on the share price of the Company and the originally announced conversion factor of 0.833 Lloyds Banking Group plc shares for each HBOS share. However, a number of factors led to negative goodwill being recognised on completion of the transaction.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

By the time of the recommended offer, it had become increasingly difficult for HBOS to raise funds in wholesale markets and HBOS faced an outflow of customer deposits, reflecting reduced investor and depositor confidence. Subsequent to the announcement of the offer, turbulence in the markets continued, fuelled by concerns about credit risk and worsening economic conditions. For HBOS, confidence continued to deteriorate amid ongoing funding difficulties and concerns over the extent of future credit losses. Measures by national authorities and central banks failed to stem this turbulence and the UK Government decided in October 2008 that it would be appropriate for the UK banking sector to increase its level of capitalisation. The capital raising, underwritten by the UK Government, was made available to HBOS on condition that the acquisition by the Company completed. As a consequence of the capital that HBOS was required to issue and the impact of market conditions on the future prospects of the new group, the terms of the final agreed offer were revised down to a ratio of 0.605. Additionally, the share price of the Company fell from 280p at the date of the announcement to 98.4p on 15 January 2009 reflecting both the dilutive impact of the capital that the Company raised and the turmoil in the banking sector and equity markets in general. These factors combined to reduce the value of the consideration for HBOS.

5. Amortisation of purchased intangibles and goodwill impairment

A total of £4,650 million of the customer-related intangibles, brands, core deposit intangibles and purchased credit card relationships were recognised on the acquisition of HBOS and these are being amortised over their estimated useful lives, where this has been determined to be finite. This has resulted in a charge of £753 million in the year ended 31 December 2009.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income. The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased and the core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates.

The Group reviews goodwill held on its balance sheet for impairment at least annually or when events or changes in economic circumstances indicate that an impairment may have taken place. Goodwill attributable to the Group s asset finance business, for which an impairment charge of £100 million was recognised in the Group s financial statements for the year ended 31 December 2008, has again been reviewed for impairment in 2009 due to the continuing uncertainties over the short-term macroeconomic environment. As a consequence, the carrying value of the consumer finance cash generating unit within Asset Finance has been reassessed resulting in an additional goodwill impairment charge of £240 million.

The charge in 2008 of £258 million comprised impairment of goodwill, principally in relation to the heritage Lloyds TSB asset finance operations, the ICC business banking division in Ireland and a specialist area of the HBOS UK credit card business.

6. Pre-acquisition results of HBOS plc

The acquisition of HBOS plc on 16 January 2009 has had a significant effect on the comparability of the Group s financial position and results, as a consequence, the combined businesses basis results are prepared as if HBOS had been owned by the Group for the full year 2009 and throughout 2008.

7. Insurance grossing adjustment

The Group s insurance businesses income statements include income and expenditure which are attributable to the policyholders of the Group s long-term assurance funds. These items have no impact upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the business, these items are shown net on a separate line.

8. Results of BankWest and St. Andrews

As explained below, HBOS sold part of its Australian operations in December 2008, the trading results of these businesses up to the date of sale have been excluded from the combined businesses basis results.

9. Loss on disposal of businesses

On 19 December 2008, HBOS completed the sale of part of its Australian operations, principally Bank of Western Australia Limited and St. Andrews Australia Pty Limited, to Commonwealth Bank of Australia Limited; this resulted in a pre-tax loss on disposal of £845 million.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RETAIL

Retail is the largest retail bank in the UK and the leading provider of current accounts, savings, personal loans, credit cards and mortgages. With its strong stable of brands including Lloyds TSB, Halifax, Bank of Scotland, Birmingham Midshires and Cheltenham & Gloucester, at 31 December 2009 Retail served over 30 million customers through one of the largest branch and fee free ATM networks in the UK.

At 31 December 2009, Retail had approximately 22 million current account customers and provided social banking to over 4 million people through basic banking or social banking accounts. It was also the largest provider of personal loans in the UK, as well as being the UK s leading credit card issuer. Retail provides one in four residential mortgages making it the leading UK mortgage lender as well as being a major provider of home finance for the first time buyer. Retail is the largest private sector savings provider in the UK, with over 21 million savers at 31 December 2009. It is also a major general insurance and bancassurance distributor, selling a wide range of long-term savings, investment and general insurance products.

	2009	2008
	£m	£m
Net interest income	**7,970**	8,454
Other income	**1,804**	2,739
Total income	**9,774**	11,193
Operating expenses	**(4,566)**	(4,963)
Trading surplus	**5,208**	6,230
Impairment	**(4,227)**	(3,695)
Share of results of joint ventures and associates	**(6)**	7
Profit before tax and fair value unwind	**975**	2,542
Fair value unwind	**407**	
Profit before tax	**1,382**	2,542

Profit before tax from Retail was £1,160 million, or 46 per cent, lower at £1,382 million in 2009 compared to £2,542 million in 2008; profit in 2009 included a credit of £407 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind decreased by £1,567 million, or 62 per cent, to £975 million in 2009 compared to £2,542 million in 2008. This decrease was driven by higher impairment losses and lower income, partly offset by a reduction in operating expenses.

Total income decreased by £1,419 million, or 13 per cent, to £9,774 million in 2009 compared to £11,193 million in 2008, reflecting a reduction in margins, lower payment protection income and non-recurring one-off income in 2008. Total income was analysed as follows:

	2009	2008
	£m	£m
Mortgages and Savings	**3,667**	5,009
Consumer Banking	**6,107**	6,184
Total income	**9,774**	11,193

Total income in Mortgages and Savings has decreased by £1,342 million, or 27 per cent, to £3,667 million in 2009 compared to £5,009 million in 2008. The reduction in Mortgage income reflected increased wholesale money market funding costs, which was partly offset by higher asset pricing. Lower income in Savings was the result of margin pressures arising from lower base rates and the competitive environment, the impact of which was partly offset by higher customer deposits.

Income within Consumer Banking (where the principal products are current accounts and unsecured lending) was £77 million, or 1 per cent, lower at £6,107 million in 2009 compared to £6,184 million in 2008. On 1 January 2009 Retail introduced a monthly premium payment protection product and ceased selling single premium products. This new product offers customers the benefit of monthly payments and income is recognised over the life of the loan rather than all being recognised in the first year. This reduction in income, together with the effect of lower loan volumes, was broadly offset by an improved performance across the rest of Consumer Banking, including benefits from asset re-pricing.

Lending to customers in Retail, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £6,019 million, or 2 per cent, lower at £371,058 million in 2009 compared to £377,077 million in 2008; this reflects the impact of customers reducing their personal indebtedness and not taking on new financial commitments in the current difficult economic environment.

Retail continued to build its mortgage business in a contracting market by focusing on the prime mortgage market, particularly through the branch network rather than intermediaries, whilst maintaining a prudent approach to risk. Gross new mortgage lending totalled £34,666 million during 2009, compared to £78,058 million in 2008, representing a market share of 24 per cent. Retail has maintained its commitment to the housing market and first time buyers, with more than 60 per cent of new lending in 2009 being for house purchase rather than for re-mortgage. The average loan-to-value ratio at the end of 2009 was 54.8 per cent compared with 54.9 per cent at the end of 2008, whilst the average loan-to-value ratio on new residential lending in 2009 was 59.3 per cent compared with 63.1 per cent in 2008. Specialist lending balances (self certified and sub-prime) decreased slowly following the decision, at the start of the year, to withdraw from this market. New buy-to-let lending remained broadly flat at 13 per cent of total new mortgage lending; however, redemptions in this book were low.

Buy-to-let mortgage balances have increased by £2,872 million in the year. Retail continued to carefully assess the risks of such lending and as a result the average loan-to-value on new lending in the buy-to-let portfolio has fallen to 65.6 per cent at the end of 2009 compared to 73.1 per cent at the end of 2008.

Customer deposits were £7,867 million, or 4 per cent, higher at £224,149 million in 2009 compared to £216,282 million in 2008 despite the high level of term deposits maturing during the period, as a result of Halifax and Bank of Scotland deposit gathering activities in the first half of 2008. Current account balances have increased by 15 per cent in the year resulting from growth in the number of current accounts and the low interest rate environment.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Retail s net interest margin decreased by 18 basis points to 1.97 per cent in 2009 compared to 2.15 per cent in 2008, reflecting higher wholesale funding costs and reduced margins on savings products due to the low base rate environment, partly offset by higher asset pricing which led to a stronger margin in the second half of 2009.

Operating expenses decreased by £397 million, or 8 per cent, to £4,566 million in 2009 compared to £4,963 million in 2008. This decrease was driven primarily by a focus on cost control, cost savings resulting from integrating the two businesses and the benefit of a lower Financial Services Compensation Scheme levy. The reduction in operating expenses resulting from integrating the Lloyds TSB and HBOS retail businesses was delivered through streamlining management structures, consolidating the number of mortgage operational sites, integrating and simplifying the mortgage operating model, procurement savings from the rationalisation of suppliers and property savings through the consolidation of sites.

Impairment losses on loans and advances increased by £532 million, or 14 per cent, to £4,227 million in 2009 compared to £3,695 million in 2008. Impairment losses as a percentage of average advances were 1.11 per cent in 2009 compared to 0.97 per cent in 2008. Higher unemployment and the weak economy drove a significant increase in unsecured impairments which was partly offset by a lower secured impairment charge as house prices stabilised. Unsecured impairment losses are sensitive to economic conditions, particularly unemployment levels; consequently the 2009 impairment charge increased by £1,038 million to £3,438 million. The stabilisation of the housing market, in combination with lower interest rates and prudent risk management, has resulted in the secured impairment charge decreasing in 2009 by £506 million to £789 million.

Arrears levels in the secured portfolios were higher than 2008 but improved in the second half of 2009, and remained below the industry average. The percentage of mortgage cases more than three months in arrears increased to 2.3 per cent at 31 December 2009 compared to 1.8 per cent as at 31 December 2008. The stock of repossessed properties reduced by 32 per cent to 2,720 properties compared to 4,011 properties at the end of 2008 and, as a proportion of total accounts, remains lower than the industry average. Currently, average proceeds from the sale of repossessed properties are in excess of average valuations assumed in Retail s provisioning models.

Impaired loans in the unsecured lending portfolio, as at 31 December 2009, totalled £3,819 million, or 11.9 per cent of closing advances (after writing off some £2,100 million of loans provided against in earlier years). This compared with £5,350 million, or 14.7 per cent of closing advances at 31 December 2008; however, on an equivalent basis (adjusting for the write-off in 2009) impaired loans at 31 December 2008 totalled some £3,250 million, or 8.9 per cent of advances. The underlying increase in impaired loans which occurred in 2009 reflected the weak economy, particularly rising unemployment. During 2009 a number of actions have been taken which improved delinquency rates on new business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WHOLESALE

The Wholesale division serves in excess of a million businesses, ranging from start-ups and small enterprises to global corporations, with a range of propositions fully segmented according to customer need. The enlarged division, following the acquisition of HBOS, comprises Corporate Markets, Treasury and Trading and Asset Finance.

Corporate Markets comprises Corporate, Commercial, Corporate Real Estate, Specialist Finance and Wholesale Markets. Corporate, Commercial and Corporate Real Estate provide relationship-based banking, risk management and advisory services to corporate and commercial customers principally in the UK. Relationships with customers with an annual turnover greater than £15 million are managed within Corporate, and commercial property-based relationships (including hotel, property-based leisure and construction) are generally managed within the Corporate Real Estate business. Commercial provides financial services to business customers ranging from new start-ups to those with a turnover of up to £15 million and invoice discounting and factoring services to a broader range of customers. Specialist Finance includes the acquisition finance and private equity businesses; all new business is being written under the brands of Lloyds Acquisition Finance or Lloyds Development Capital. Wholesale Markets provides risk management solutions, specialised lending, capital markets advisory and multi-product financing solutions to its customers, whilst managing the Group s own portfolio of structured credit investments and treasury assets.

Treasury and Trading s role is to provide access to financial markets in order to meet the Group s balance sheet management requirements, and provides trading infrastructure to support execution of customer-driven risk management transactions, whilst operating within a well controlled and conservative risk appetite.

Asset Finance consists of a number of leasing, hire purchase and speciality lending businesses including Contract Hire (Lex, Autolease and Hill Hire), Specialist Assets and Consumer Finance (Black Horse Motor and Personal Finance). Hire purchase is a form of consumer financing where a customer takes possession of goods on payment of an initial deposit but the legal title to the goods does not pass to the customer until the agreed number of instalments have been paid and the option to purchase has been exercised.

	2009 £m	2008 £m
Net interest income	**4,710**	5,752
Other income	**4,199**	(302)
Total income	**8,909**	5,450
Operating expenses	**(4,106)**	(4,591)
Trading surplus	**4,803**	859
Impairment	**(15,683)**	(10,394)
Share of results of joint ventures and associates	**(720)**	(944)
Loss before tax and fair value unwind	**(11,600)**	(10,479)
Fair value unwind	**6,897**	
Loss before tax	**(4,703)**	(10,479)

Loss before tax from Wholesale improved by £5,776 million to a loss of £4,703 million in 2009 compared to a loss of £10,479 million in 2008; however, the loss in 2009 included a credit of £6,897 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind deteriorated by £1,121 million to a loss of £11,600 million in 2009 compared to a loss of £10,479 million in 2008. This deterioration was driven by higher impairment losses, only partly offset by an increase in other operating income and a decrease in operating expenses.

Total income increased by £3,459 million, or 63 per cent, to £8,909 million in 2009 compared to £5,450 million in 2008, driven by a large increase in other income.

Lending to customers in Wholesale, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £42,754 million, or 18 per cent, lower at £191,808 million in 2009 compared to £234,562 million in 2008.

Customer deposits were £4,552 million, or 3 per cent, lower at £153,389 million in 2009 compared to £157,941 million in 2008.

Net interest income was £1,042 million, or 18 per cent, lower at £4,710 million in 2009 compared to £5,752 million in 2008. The net interest margin, adjusted to exclude products where either the funding costs or the related revenues are recognised in other income, declined by 33 basis points to 1.52 per cent in 2009 compared to 1.85 per cent in 2008. This reduction in income and margin reflected higher wholesale funding costs partly offset by higher asset pricing.

Other income was £4,501 million higher at £4,199 million in 2009 compared to a deficit of £302 million in 2008. Other income in 2008 had been significantly reduced due to the effect of the dislocation in credit markets which resulted in investment valuation write-downs in the Wholesale business; these factors were not repeated in 2009. Other income in 2009 also benefited from good transaction volumes in capital markets and strong flows of client-driven derivative transactions at improved spreads.

Operating expenses decreased by £485 million, or 11 per cent, to £4,106 million in 2009 compared to £4,591 million in 2008. Operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments; excluding this item from 2008, operating expenses decreased by £305 million, or 7 per cent, to £4,106 million in 2009 compared to £4,411 million in 2008. This decrease reflects reduced levels of operating lease business and cost savings achieved from the integration programme, partly offset by increased investment in Wholesale s customer focused business support functions.

Impairment losses increased by £5,289 million to £15,683 million in 2009 compared to £10,394 million in 2008. Impairment losses for loans and advances as a percentage of average loans and advances to customers were 5.92 per cent in 2009 compared to 3.32 per cent in 2008. These increased impairment losses reflect the continued weak economic climate, higher levels of corporate failures, and application of prudent Lloyds Banking Group provisioning policy, notably in HBOS Corporate Real Estate and HBOS Corporate (UK and US) transactions. However, total impairment losses are expected to have peaked in the first half of 2009, amounting to £9,738 million, compared to £5,945 million in the second half, a reduction of 39 per cent.

Wholesale s share of results of joint ventures and associates improved by £224 million, or 24 per cent, to a loss of £720 million in 2009 compared to a loss of £944 million in 2008; there were lower levels of write-offs in 2009 as the majority of the book is fully written-off.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WEALTH AND INTERNATIONAL

Wealth and International is a new division formed in 2009 to give increased focus and momentum to the private banking and asset management businesses and to closely co-ordinate the management of the Group s international businesses.

The Wealth business comprises private banking, wealth and asset management businesses in the UK and overseas. The key operations are UK and International Private Banking, which operate under the Lloyds TSB and Bank of Scotland brands, the Channel Islands and Isle of Man offshore businesses, the expatriates business and the Asset Management business which, following the completion of the sale of Insight Investment, is now consolidated within Scottish Widows Investment Partnership. In addition the Group holds a 60 per cent stake in St James s Place plc and a 55 per cent stake in Invista Real Estate, respectively the UK s largest independent listed wealth manager and real estate fund management group.

The International business comprises the Group s other international banking businesses outside the UK, with the exception of corporate business in North America which is managed through the Group s Wholesale division. These largely comprise corporate, commercial and asset finance businesses in Australia, Ireland and Continental Europe and retail businesses in Ireland, Germany and the Netherlands.

	2009 **£m**	2008 £m
Net interest income	**1,217**	1,314
Other income	**1,128**	1,191
Total Income	**2,345**	2,505
Operating expenses	**(1,544)**	(1,476)
Trading surplus	**801**	1,029
Impairment	**(4,078)**	(731)
Share of results of joint ventures and associates	**(21)**	(21)
Profit (loss) before tax and fair value unwind	**(3,298)**	277
Fair value unwind	**942**	
Profit (loss) before tax	**(2,356)**	277
Wealth	**198**	369
International	**(3,496)**	(92)
Profit (loss) before tax and fair value unwind	**(3,298)**	277

Profit before tax from Wealth and International was £2,633 million lower at a loss of £2,356 million in 2009 compared to a profit of £277 million in 2008; the loss in 2009 included a credit of £942 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind decreased by £3,575 million to a loss of £3,298 million in 2009 compared to a profit of £277 million in 2008. This deterioration was driven by higher impairment losses.

Total income decreased by £160 million, or 6 per cent, to £2,345 million in 2009 compared to £2,505 million in 2008. This decrease reflects lower net interest margins, and the impact of lower global stock markets particularly in the first half of the year, partly offset by favourable foreign exchange movements.

Lending to customers in Wealth and International, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £1,005 million, or 2 per cent, lower at £63,548 million in 2009 compared to £64,553 million in 2008 as net repayments and increased impairment provisions in the International businesses have been offset by the transfer of a European loan portfolio of some £7,000 million from Wholesale division.

Customer deposits were £5,058 million, or 15 per cent, lower at £29,037 million in 2009 compared to £34,095 million in 2008 primarily due to outflows in Ireland reflecting aggressive pricing from competitors who have also benefited from the Irish Government deposit guarantee.

Net interest income was £97 million, or 7 per cent, lower at £1,217 million in 2009 compared to £1,314 million in 2008. The net interest margin, adjusted to exclude earnings on policyholder funds and products where either the funding costs or the related revenues are recognised in other income, declined by 35 basis points to 1.71 per cent in 2009 compared to 2.06 per cent in 2008. This margin reduction reflects higher wholesale funding costs and lower deposit margins in the low base rate environment, partly offset by the impact of strong portfolio management in International and higher asset pricing leading to higher margins.

Other income was £63 million, or 5 per cent, lower at £1,128 million in 2009 compared to £1,191 million in 2008. This decrease was driven by falls in global stock markets, particularly in the first half of 2009, impacting sales volumes and fee income across all Wealth businesses; partly offset by favourable exchange movements in the International operations.

Operating expenses increased by £68 million, or 5 per cent, to £1,544 million in 2009 compared to £1,476 million in 2008. Adverse foreign exchange movements increased operating expenses in both the Wealth and the International businesses and additional costs resulted from investments to increase distribution capacity in Private Banking to support future growth plans, additional costs associated with the transitional services following the disposal by HBOS of BankWest and St. Andrews Australia in December 2008, the development of International s deposit taking operation in Germany and increased risk management resources to manage impaired asset portfolios in Ireland and Australia. These increases in costs were partly offset by cost savings from integration, particularly in the Asset Management business.

Impairment losses increased by £3,347 million to £4,078 million in 2009 compared to £731 million in 2008. This reflects the significant deterioration in the credit risk environment in Ireland and Australia as well as the impact of the economic environment on the UK Private Banking and Expatriate lending portfolios. Of the total impairment losses in 2009, £2,949 million arose in Ireland which experienced a significant deterioration in asset values driven by the collapse in liquidity and severe decline in the property sector where commercial real estate values fell by over 50 per cent and house prices by over 25 per cent from their peak. A further £849 million of the total impairment losses in 2009 arose in Australia, driven by concentrations in property and in other sectors such as media, printing and transport which have been hardest hit by the downturn. Business Support Units have been established in both Ireland and Australia, supplemented by a divisional sanctioning process, to provide independent divisional oversight and control of the portfolios.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE

The Insurance division consists of three business units:

LIFE, PENSIONS AND INVESTMENTS UK

The UK Life, Pensions and Investments business is the leading bancassurance provider in the UK and has one of the largest intermediary sales forces in the industry. The business includes Scottish Widows which, for a number of years, has been a subsidiary of the Lloyds TSB Group and the provider of long-term savings and investment products distributed through all channels of that group. Following the acquisition of HBOS, the Life, Pensions and Investments business also includes business written through the intermediary and bancassurance channels under the Clerical Medical and Halifax brands respectively.

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

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

Other life and pensions products are generally written from Non-Profit sub-funds.

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

LIFE, PENSIONS AND INVESTMENTS EUROPE

The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands. The business unit was included within the International division of the former HBOS group.

GENERAL INSURANCE

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

	2009 **£m**	2008 £m
Net interest income	**(287)**	(345)
Other income	**2,944**	3,493
Total income	**2,657**	3,148
Insurance claims	**(637)**	(481)
Total income, net of insurance claims	**2,020**	2,667
Operating expenses	**(974)**	(1,129)
Share of results of joint ventures and associates	**(22)**	2
Profit before tax and fair value unwind	**1,024**	1,540
Fair value unwind	**(49)**	

Profit before tax		**975**	1,540
Profit before tax and fair value unwind by business unit			
Life, Pensions and Investments	UK business	**617**	826
	European business	**75**	149
General Insurance		**367**	537
Other		**(35)**	28
Profit before tax and fair value unwind		**1,024**	1,540

Profit before tax from Insurance was £565 million lower at £975 million in 2009 compared to £1,540 million in 2008. The profit in 2009 included a charge of £49 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind was £516 million lower at £1,024 million in 2009 compared to £1,540 million in 2008. This deterioration in profits followed a reduction in income and an increase in claims, due to factors including demanding market conditions, partly offset by a decrease in operating expenses.

Total income decreased by £491 million, or 16 per cent, to £2,657 million in 2009 compared to £3,148 million in 2008 due to the non-recurrence of £334 million of HBOS legacy one-off benefits, principally in Life, Pensions and Investments, enjoyed in 2008 and the impact of challenging economic conditions driving lower sales and returns, partially offset by significantly lower charges for policyholder lapses.

Net interest income was £58 million, or 17 per cent, better at a deficit of £287 million in 2009 compared to a deficit of £345 million in 2008.

Other income was £549 million, or 16 per cent, lower at £2,944 million in 2009 compared to £3,493 million in 2008. Within the life and pensions activities, new business profit was significantly impacted by the general contraction in the life, savings and investments market and the reduction also reflects the integration of the intermediary sales forces and the withdrawal of a number of legacy HBOS products with poor returns. Existing business profit within the UK life and pensions activities reduced by 10 per cent, this includes a reduction in expected return, reflecting lower asset values resulting from adverse investment markets in 2008, a lower assumed rate of return and the non-recurrence of one-off benefits enjoyed by HBOS in 2008. These impacts have been partly offset by a significant reduction in charges for policyholder lapses in 2009. Within the general insurance activities, income was lower principally due to payment protection insurance income decreasing as a result of the market-wide move to monthly premiums on payment protection, partly offset by lower distribution commission payable to the Retail division.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance claims were £156 million, or 32 per cent, higher at £637 million in 2009 compared to £481 million in 2008, primarily due to higher payment protection insurance claims related to unemployment. Whilst property claims were impacted by flooding and freeze claims in the final quarter of 2009, benefits from ongoing investments in claims processes continue to be realised.

Operating expenses decreased by £155 million, or 14 percent, to £974 million in 2009 compared to £1,129 million in 2008; this is mainly due to continued focus on cost management and delivering integration synergies.

Insurance s share of results of joint ventures and associates deteriorated to a loss of £22 million in 2009 compared to a profit of £2 million in 2008.

LIFE, PENSIONS AND INVESTMENTS

UK BUSINESS

		2009 **£m**	2008 £m
Net interest income		**(273)**	(282)
Other income		**1,474**	1,758
Total income		**1,201**	1,476
Operating expenses		**(584)**	(650)
Profit before tax and fair value unwind		**617**	826
Profit before tax and fair value unwind analysis			
New business profit	insurance business[1]	**328**	465
	investment business[1]	**(196)**	(247)
Total new business profit		**132**	218
Existing business profit		**483**	534
Expected return on shareholders net assets		**2**	74
Profit before tax and fair value unwind		**617**	826

1 As required under IFRS, products are split between insurance and investment contracts depending on the level of insurance risk contained. For insurance contracts, the new business profit includes the net present value of profits expected to emerge over the lifetime of the contract, including profits anticipated in periods after the year of sale; for investment contracts the figure reflects the profit in the year of sale only, after allowing for the deferral of initial income and expenses. Consequently the recognition of profit for investment contracts is deferred relative to insurance contracts.

Profit before tax and fair value unwind decreased by £209 million, or 25 per cent, to £617 million in 2009 compared to £826 million in 2008. New business profit was significantly impacted by the general contraction in the life, savings and investments market but the reduction also reflects the integration of the intermediary sales forces and the withdrawal of a number of legacy HBOS products with poor returns.

Existing business profit reduced by £51 million, or 10 per cent, to £483 million in 2009 compared to £534 million in 2008. This reflects a reduction in expected return, reflecting lower asset values resulting from adverse investment markets in 2008, a lower assumed rate of return and the non-recurrence of one-off benefits in HBOS in 2008, principally relating to a move to a more market consistent basis of embedded value and enhancements to the bond proposition. Those impacts have been partly offset by a significant reduction in charges for policyholder lapses in 2009.

Expected returns on shareholders net assets were impacted both by a lower assumed rate of return and by reduced asset values as a result of severe market falls in 2008.

EUROPEAN BUSINESS

Profit before tax and fair value unwind decreased by £74 million, or 50 per cent to £75 million in 2009 compared to £149 million in 2008. New business profits reduced by £32 million driven by lower sales, reflecting economic and market conditions. Existing business profits decreased, primarily due to lower expected returns. In 2008, as a result of moving to a more market consistent basis of embedded value in HBOS, a one-off benefit of £123 million arose. The impact of this was largely offset by a significant reduction in charges for policyholder lapses in 2009.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NEW BUSINESS

The table below provides an analysis of the present value of new business premiums (PVNBP) for business written by the Insurance division, split between the UK and European Life, Pensions and Investments businesses. PVNBP is the measure of new business premiums for the life and pensions business and OEIC sales that management monitors because it provides an indication of both the performance and the profitability of the business this is calculated as the value of single premiums plus the discounted present value of future expected regular premiums.

		2009			2008	
	UK £m	**Europe £m**	**Total £m**	UK £m	Europe £m	Total £m
Protection	**519**	**49**	**568**	492	51	543
Payment protection	**153**		**153**	679		679
Savings and investments	**2,689**	**312**	**3,001**	4,149	372	4,521
Individual pensions	**2,275**	**185**	**2,460**	4,216	306	4,522
Corporate and other pensions	**2,600**		**2,600**	2,940		2,940
Retirement income	**887**		**887**	1,451		1,451
Managed fund business	**146**		**146**	216		216
Life and pensions	**9,269**	**546**	**9,815**	14,143	729	14,872
OEICs	**3,704**		**3,704**	3,303		3,303
Total	**12,973**	**546**	**13,519**	17,446	729	18,175
Analysis by channel						
Bancassurance excluding payment protection	**6,844**		**6,844**	7,677		7,677
Payment protection	**153**		**153**	679		679
Bancassurance	**6,997**		**6,997**	8,356		8,356
Intermediary	**5,639**	**546**	**6,185**	8,704	729	9,433
Direct	**337**		**337**	386		386
Total	**12,973**	**546**	**13,519**	17,446	729	18,175

The present value of new business premiums reduced by £4,656 million, or 26 per cent, to £13,519 million in 2009 compared to £18,175 million in 2008 reflecting both a general contraction in the UK and European markets as well as the re-positioning of the UK intermediary product range. Sales through the intermediary channel were significantly impacted as the UK intermediary sales forces were integrated and a number of legacy HBOS products with poor returns were withdrawn. As a result, sales in the intermediary channel reduced by 34 per cent. Sales through the bancassurance channel, excluding payment protection, continued to perform relatively robustly with a reduction of 11 per cent. This includes Scottish Widows sales through the bancassurance network which showed good growth of 18 per cent. Sales of OEIC products were strong with an increase of 12 per cent in 2009.

GENERAL INSURANCE

	2009 £m	2008 £m
Home insurance		
Underwriting income (net of reinsurance)	**897**	885
Commission receivable	**71**	50
Commission payable	**(94)**	(70)
	874	865
Payment protection insurance		
Underwriting income (net of reinsurance)	**731**	860

Commission receivable	**13**	428
Commission payable	**(395)**	(923)
	349	365
Other		
Underwriting income (net of reinsurance)	**8**	20
Commission receivable	**69**	71
Commission payable	**(28)**	(36)
Other (including investment income)	**(6)**	93
	43	148
Net operating income	**1,266**	1,378
Claims paid on insurance contracts (net of reinsurance)	**(637)**	(481)
Operating income, net of claims	**629**	897
Operating expenses	**(262)**	(360)
Profit before tax and fair value unwind	**367**	537

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Profit before tax and fair value unwind from General Insurance decreased by £170 million, or 32 per cent, to £367 million in 2009 compared to £537 million in 2008.

Claims were £156 million, or 32 per cent, higher at £637 million compared to £481 million in 2008, primarily due to higher payment protection insurance claims related to unemployment. Whilst property claims were impacted by flooding and freeze claims in the final quarter of 2009, benefits from ongoing investments in claims processes continue to be realised.

Against the background of a particularly competitive market in which the general insurance business has a leading position, home insurance income generated modest growth of £9 million, or 1 per cent to £874 million in 2009 compared to £865 million in 2008. Payment protection insurance income decreased by £16 million, or 4 per cent, to £349 million in 2009 compared to £365 million in 2008 as a result of the market-wide move to monthly premiums on payment protection, partly offset by lower distribution commission payable to the Retail division.

Other income has reduced, primarily reflecting lower interest rates and the allocation of certain charges.

Operating expenses decreased by £98 million, or 27 per cent, to £262 million in 2009 compared to £360 million in 2008. Adjusting for the reclassification of claims handling expenses into claims paid and non-recurring marketing spend in 2008, costs improved by 10 per cent year on year, reflecting continued focus on cost management and cost savings achieved through the integration.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GROUP OPERATIONS

	2009 £m	2008 £m
Net interest income	**(69)**	(59)
Other income	**20**	35
Total income	**(49)**	(24)
Direct costs:		
Information technology	**(1,265)**	(1,347)
Operations	**(555)**	(542)
Property	**(979)**	(1,019)
Procurement	**(166)**	(159)
Support functions	**(101)**	(89)
	(3,066)	(3,156)
Result before recharges to divisions	**(3,115)**	(3,180)
Total net recharges to divisions	**2,941**	3,100
Share of results of joint ventures and associates	**3**	4
Loss before tax and fair value unwind	**(171)**	(76)
Fair value unwind	**22**	
Loss before tax	**(149)**	(76)

Loss before tax from Group Operations deteriorated by £73 million to £149 million in 2009 compared to £76 million in 2008. The loss in 2009 included a credit of £22 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind deteriorated by £95 million to £171 million in 2009 compared to £76 million in 2008.

Total income, excluding recharges to divisions, decreased by £25 million, to a deficit of £49 million in 2009 compared to a deficit of £24 million in 2008. Net interest income was £10 million, or 17 per cent, lower at a net expense of £69 million in 2009 compared to a net expense of £59 million in 2008. Other income was £15 million, or 43 per cent, lower at £20 million in 2009 compared to £35 million in 2008.

Direct costs were £90 million, or 3 per cent, lower at £3,066 million in 2009 compared to £3,156 million in 2008; this reflects the impact of integration synergies and a continued focus on cost management.

IT costs decreased due to the early realisation of synergy savings following the consolidation of IT operations across the Group in addition to lower investment spend as project activity was rationalised and replaced by integration activity; property costs were also lower, primarily due to the realisation of synergy savings as a result of the integration and the consolidation of premises (which has been achieved at a faster rate than originally anticipated).

Recharges to divisions were £159m, or 5 per cent, lower at £2,941 million in 2009 compared to £3,100 million in 2008.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CENTRAL ITEMS

	2009 **£m**	2008 £m
Net interest income	**(815)**	(213)
Other income	**1,780**	(223)
Total income	**965**	(436)
Operating expenses	**(294)**	(21)
Trading surplus (deficit)	**671**	(457)
Impairment		(60)
Share of results of joint ventures and associates	**(1)**	
Profit (loss) before tax and fair value unwind	**670**	(517)
Fair value unwind	**(2,119)**	
Loss before tax	**(1,449)**	(517)

Central items are comprised of three main elements:

1 The residual net interest position arising from the Group s processes to allocate the following elements of net interest income to the divisions:

interest on the Group s equity position;

net interest margin cost resulting from central capital activities, primarily arising on the management of senior and subordinated debt and preference shares net of such cost allocated to the divisions; and

cost to the Group of funding wholesale and liquidity balances.

2 The charge for payments to the Lloyds TSB Foundations: the four independent Lloyds TSB Foundations support registered charities throughout the UK that enable people, particularly the disabled and disadvantaged, to play a fuller role in society.

3 Central costs and other unallocated items: these relate to the on-going costs of central group activities including those of group corporate treasury (including the central hedge function), internal group audit, group risk, group compliance, group finance and group IT and operations.

Loss before tax from Central items deteriorated by £932 million to £1,449 million in 2009 compared to £517 million in 2008. The loss in 2009 included a charge of £2,119 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind was £670 million in 2009 compared to a loss of £517 million in 2008.

Total income increased by £1,401 million, to £965 million in 2009 compared to a deficit of £436 million in 2008. Net interest income was £602 million lower at a net expense of £815 million in 2009 compared to a net expense of £213 million in 2008. Other income was £2,003 million higher at £1,780 million in 2009 compared to a deficit of £223 million in 2008; this was primarily as a result of gains arising when the Group exchanged certain existing subordinated debt securities for new securities. These exchanges resulted in a gain on extinguishment of the existing liability of £1,498 million (of which £1,468 million is reflected in Central items), being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs.

Operating expenses were £273 million higher at £294 million in 2009 compared to £21 million in 2008; this was due in part to higher professional fees and other costs associated with a number of group-wide projects, including the proposed participation in the Government Asset Protection Scheme, and an increase in the amount of pension costs held centrally.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMBINED BUSINESSES BASIS SUMMARY 2009 COMPARED WITH 2008

Readers should be aware that the combined businesses basis has been presented for comparative purposes only and is neither intended to provide proforma information nor to show the results of the Group as if the acquisition of HBOS had taken place at an earlier date. Readers should also note that HBOS was not managed by the current management of Lloyds Banking Group in 2008.

As noted on page 2, the combined businesses basis segmental results for 2009 and 2008 are presented in accordance with IFRS. However, the aggregated total of the combined businesses segmental results constitutes a non-GAAP measure as defined by the SEC.

The acquisition of HBOS plc on 16 January 2009 has had a significant impact on the results of the Group. Comparisons of the Group s performance on a statutory basis are, therefore, dominated by the impact of the acquisition of HBOS; the 2009 statutory results include the results of HBOS from 16 January 2009, together with the effects of the unwind of fair value adjustments made to the HBOS balance sheet on acquisition, and the 2008 statutory results do not include any results of HBOS.

Management uses the aggregated total of the combined businesses segmental results, a non-GAAP measure, as a measure of performance, and believes that it provides important information for investors, because it is a comparable representation of the Group s performance. Profit before tax is the comparable GAAP measure to profit before tax on a combined businesses basis; a reconciliation of the Group s statutory income statement to its combined businesses income statement is shown below. Readers should be aware that the combined businesses basis excludes certain items, as indicated in the tables below, reflected in the Group s statutory results and includes certain items, also indicated in the tables below, not reflected in the Group s statutory results. The Group refers readers to the discussion of its statutory results on pages 14 to 23.

Set out below is a reconciliation from the Group s statutory results to the combined businesses basis, together with a brief commentary.

			Removal of:				
2009	**Lloyds Banking Group statutory £m**	**Pre-acquisition results of HBOS £m**	**GAPS fee and acquisition related items[1] £m**	**Volatility £m**	**Insurance gross up £m**	**Fair value unwind £m**	**Combined businesses £m**
Net interest income	**9,026**	**243**		**11**	**1,280**	**2,166**	**12,726**
Other income	**36,271**	**(1,123)**		**(479)**	**(21,659)**	**(1,135)**	**11,875**
Total income	**45,297**	**(880)**		**(468)**	**(20,379)**	**1,031**	**24,601**
Insurance claims	**(22,019)**	**1,349**			**20,318**	**(285)**	**(637)**
Total income, net of insurance claims	**23,278**	**469**		**(468)**	**(61)**	**746**	**23,964**
Operating expenses	**(15,984)**	**(293)**	**4,589**		**61**	**18**	**(11,609)**
Trading surplus (deficit)	**7,294**	**176**	**4,589**	**(468)**		**764**	**12,355**
Impairment	**(16,673)**	**(456)**				**(6,859)**	**(23,988)**
Share of results of joint ventures and associates	**(752)**			**(10)**		**(5)**	**(767)**
Gain on acquisition	**11,173**		**(11,173)**				
Fair value unwind						**6,100**	**6,100**
Profit (loss) before tax	**1,042**	**(280)**	**(6,584)**	**(478)**			**(6,300)**

1 Includes the GAPS fee (£2,500 million), integration costs (£1,096 million), amortisation of purchased intangibles (£753 million), goodwill impairment (£240 million) and gain on acquisition.

					Removal of:			
2008	Lloyds TSB statutory[1] £m	HBOS statutory £m	Reclass-ifications £m	BankWest and St. Andrews £m	Volatility £m	Amortisation of purchased intangibles and goodwill impairment £m	Insurance gross up £m	Combined businesses £m
Net interest income	7,718	8,171	1,906	(524)	(9)		(2,359)	14,903
Other income	(709)	(4,559)	(234)	(148)	2,358		10,225	6,933
Total income	7,009	3,612	1,672	(672)	2,349		7,866	21,836
Insurance claims	2,859	6,192	(1,570)				(7,962)	(481)
Total income, net of insurance claims	9,868	9,804	102	(672)	2,349		(96)	21,355
Operating expenses	(6,100)	(6,880)		400		258	86	(12,236)
Trading surplus	3,768	2,924	102	(272)	2,349	258	(10)	9,119
Impairment	(3,012)	(12,050)		182				(14,880)
Share of results of joint ventures and associates	4	(956)						(952)
Non-operating income		(743)	(102)	845				
Profit (loss) before tax	760	(10,825)		755	2,349	258	(10)	(6,713)

1 Restated for IFRS 2 (Revised).

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Profit before tax on a combined businesses basis improved by £413 million to a loss of £6,300 million in 2009 compared to a loss of £6,713 million in 2008; however, the loss in 2009 included a credit of £6,100 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind deteriorated by £5,687 million to a loss of £12,400 million in 2009 compared to a loss of £6,713 million in 2008. This deterioration was driven by higher impairment losses, only partly offset by an increase in other operating income and a decrease in operating expenses.

Total income increased by £2,765 million, or 13 per cent, to £24,601 million in 2009 compared to £21,836 million in 2008, driven by a large increase in other income.

Lending to customers, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £50,277 million, or 7 per cent, lower at £626,969 million in 2009 compared to £677,246 million in 2008.

Customer deposits were £2,421 million lower at £406,741 million in 2009 compared to £409,162 million in 2008.

Net interest income was £2,177 million, or 15 per cent, lower at £12,726 million in 2009 compared to £14,903 million in 2008. The net interest margin, adjusted to exclude products where either the funding costs or the related revenues are recognised in other income, declined by 24 basis points to 1.77 per cent in 2009 compared to 2.01 per cent in 2008.

Other income was £4,942 million, or 71 per cent, higher at £11,875 million in 2009 compared to £6,933 million in 2008. Other income in 2008 had been significantly reduced due to the effect of the dislocation in credit markets which resulted in investment valuation write-downs of £3,452 million in the Wholesale business; these factors were not repeated in 2009.

Operating expenses decreased by £627 million, or 5 per cent, to £11,609 million in 2009 compared to £12,236 million in 2008. Operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments; excluding this item from 2008, operating expenses decreased by £447 million, or 4 per cent, to £11,609 million in 2009 compared to £12,056 million in 2008.

Impairment losses increased by £9,108 million, or 61 per cent, to £23,988 million in 2009 compared to £14,880 million in 2008. Impairment losses on loans and advances to customers as a percentage of average loans and advances to customers were 3.25 per cent in 2009 compared to 1.81 per cent in 2008.

The Group s share of results of joint ventures and associates improved by £185 million, or 19 per cent, to a loss of £767 million in 2009 compared to a loss of £952 million in 2008; there were lower levels of write-offs in 2009 as the majority of the book is fully written-off.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LINE OF BUSINESS INFORMATION

2008 COMPARED WITH 2007

The requirements for IFRS segmental reporting are set out in IFRS 8 Operating Segments which mandates that an entity s segmental reporting should reflect the way in which its operations are viewed and judged by its chief operating decision maker. As a consequence, the Group s statutory segmental reporting for comparing 2008 with 2007 follows the continuing businesses basis as explained below (see also note 4 to the consolidated financial statements).

The Group Executive Committee (GEC) has been determined to be the chief operating decision maker for the Group. The Group s operating segments reflect its organisational and management structures. GEC reviews the Group s internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment s net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

The Group s activities in 2008 were organised into three financial reporting segments: UK Retail Banking, Insurance and Investments and Wholesale and International Banking.

The continuing businesses basis excluded the following items:

- insurance and policyholder interests volatility
- a provision in respect of certain historic US dollar payments
- a provision in respect of the Financial Services Compensation Scheme levy
- impairment charge in respect of goodwill
- the results of discontinued businesses
- profit on sale of businesses
- the settlement of overdraft claims.

The results of the businesses are set out below:

	2008[1] £m	2007[1] £m
UK Retail Banking	1,793	1,720
Insurance and Investments	911	748
Wholesale and International Banking	274	1,300
Central group items	(599)	(13)
Profit before tax continuing businesses	2,379	3,755

A reconciliation from the continuing businesses basis to the statutory results is set out below:

	Note	2008[1] £m	2007[1] £m
Profit before tax continuing businesses		2,379	3,755
Volatility	1		

Insurance		(746)	(277)
Policyholder interests		(471)	(222)
Discontinued businesses	2		162
Profit on sale of businesses	3		657
Provision in respect of certain historic US dollar payments	4	(180)	
Provision for Financial Services Compensation Scheme levy	5	(122)	
Goodwill impairment	6	(100)	
Settlement of overdraft claims	7		(76)
Profit before tax statutory		760	3,999

1 Restated for IFRS 2 (Revised).

1. Volatility

	2008 £m	2007 £m
Insurance volatility	(746)	(277)
Policyholder interests volatility	(471)	(222)
Total volatility	(1,217)	(499)

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Insurance volatility

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

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

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

	2008 %	2007 %
Gilt yield (gross)	4.55	4.62
Equity return (gross)	7.55	7.62
Dividend yield	3.00	3.00
Property return (gross)	7.55	7.62
Corporate bonds in unit-linked and with-profits funds (gross)	5.15	5.22
Fixed interest instruments backing annuity liabilities (gross)	5.56	5.09

During 2008, profit before tax included negative insurance volatility of £746 million, being a credit of £9 million to net interest income and a charge of £755 million to other income. During 2007, profit before tax included negative insurance volatility of £277 million, being a credit of £7 million to net interest income and a charge of £284 million to other income. The charge in 2008 mainly reflected the significant falls in global equity markets during the year, which resulted in total returns some 33 percentage points lower than the expected investment returns set out above. These lower than expected returns reduced the value of in-force business asset in respect of life insurance and participating investment contracts held on the balance sheet. The impact of the widening corporate bond credit spreads more than offset the inclusion of an allowance for the illiquidity premium, and resulted in a net reduction in the value of the annuity portfolio. Lower equity and bond prices also affected the valuation of the Group s investment held within the funds attributable to the shareholders. During 2007, the effect of widening credit risk spreads and falling gilt values more than offset the favourable impact of a modest increase in equity values and changes in market consistent assumptions.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life and pensions business. In order to provide a clearer representation of the performance of the business and consistent with the way in which it is managed, equalisation adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group s tax charge rather than being offset against the related income. The impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Other sources of volatility include the minorities share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.

During 2008, profit before tax included negative policyholder interests volatility of £471 million, being a charge to other income. During 2007, profit before tax included negative policyholder interests volatility of £222 million, being a charge to other income. In both 2007 and 2008, substantial policyholder tax losses were generated as a result of a fall in property, bond and equity values. These losses reduce future policyholder tax liabilities and led to a policyholder tax credit in both years.

2. Discontinued businesses

As explained below, the Group disposed of Lloyds TSB Registrars, Abbey Life and Dutton-Forshaw during 2007. Trading results of these businesses up to the date of sale have been excluded from the continuing businesses basis results.

3. Profit on sale of businesses

During 2007, the Group disposed of Lloyds TSB Registrars, its share registration business; Abbey Life, the UK life operation which was closed to new business in 2000; and Dutton-Forshaw, its medium-size car dealership. In addition, provision was made for payments under an indemnity given in relation to a business sold in an earlier year. Together, these transactions resulted in a profit of £657 million.

4. Provision in respect of certain historic US dollar payments

In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney s Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices; the Group provided £180 million in respect of this matter in its 2008 results.

5. Provision for Financial Services Compensation Scheme levy

The arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit taking institutions involving the Financial Services Compensation Scheme (FSCS) will result in a significant increase in the levies made by the FSCS on the industry. The Group made a provision of £122 million in respect of its then obligation for the estimated interest cost on the FSCS borrowings in its 2008 results.

6. Goodwill impairment

During 2008, the basis of goodwill allocation in parts of the Asset Finance business was changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance. The markets in which this unit operates had been affected by the UK economic downturn, which had been characterised by falling demand and increasing arrears at that point of the cycle. This, together with uncertainties over the likely short-term macroeconomic environment, resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million in 2008.

7. Settlement of overdraft claims

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

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UK RETAIL BANKING

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

The Group provided wide-reaching geographic branch coverage in England, Scotland and Wales, through over 1,950 branches of Lloyds TSB Bank, Lloyds TSB Scotland plc (Lloyds TSB Scotland) and C&G; internet banking provided online banking facilities for personal customers and telephone banking continued to grow, at the end of 2008 some 5.7 million customers had registered to use the services of PhoneBank and the automated voice response service, PhoneBank Express. The Group had one of the largest cash machine networks of any leading banking group in the UK and, at 31 December 2008, personal customers of Lloyds TSB Bank and Lloyds TSB Scotland were able to withdraw cash and check balances through over 4,200 ATMs at branches and external locations around the UK.

Lloyds TSB Bank and Lloyds TSB Scotland offered a wide range of current accounts, including interest-bearing current accounts and a range of added-value accounts; savings accounts and retail investments; and personal loans.

The Group provided a range of card-based products and services, including credit and debit cards and card transaction processing services for retailers.

In 2008 C&G was UK Retail Banking s specialist residential mortgage arranger, offering a range of mortgage products to personal customers through its own branches and those of Lloyds TSB Bank in England and Wales, as well as through the telephone, internet and postal service, Mortgage Direct; mortgages were also offered through Lloyds TSB Scotland.

UK Wealth Management provided financial planning and advice for the Group s affluent customers, providing financial solutions across investments, retirement planning and income, trusts, tax and estate planning as well as share dealing.

	2008 £m	2007 £m
Net interest income	4,110	3,695
Other income	1,766	1,797
Total income	5,876	5,492
Operating expenses	(2,611)	(2,548)
Trading surplus	3,265	2,944
Impairment	(1,472)	(1,224)
Profit before tax	1,793	1,720
Cost:income ratio	44.4%	46.4%
Total assets (year end)	£127,502m	£115,012m

Profit before tax from UK Retail Banking increased by £73 million, or 4 per cent, to £1,793 million in 2008 compared to £1,720 million in 2007.

Net interest income was £415 million, or 11 per cent, higher at £4,110 million in 2008 compared with £3,695 million in 2007, reflecting both an increase in average interest-earning assets and an improvement in the net interest margin. Average interest-earning assets were £9,234 million, or 8 per cent, higher at £120,128 million in 2008 compared to £110,894 million in 2007 as a result of lending growth, particularly within the mortgage business. Average mortgage balances were £8,652 million higher in 2008. Gross new mortgage lending for the Group totalled £27,767 million, compared to £29,431 million in 2007; net new lending totalled £10,914 million, compared to £6,647 million in 2007, resulting in a market share of net new mortgage lending of 27.5 per cent, compared to 6.2 per cent in 2007. Average balances in respect of other personal lending were £20,138 million compared with £19,426 million in 2007. Average credit card balances in 2008 were 2 per cent lower at £6,477 million compared to £6,619 million in 2007, whilst balances on personal loans and overdrafts were 7 per cent higher at £13,661 million in 2008. Overall margins in UK Retail Banking improved by 9 basis points as a result of wider margins within the unsecured personal lending business and on new

mortgages.

Other income was £31 million, or 2 per cent, lower at £1,766 million compared to £1,797 million in 2007. Higher fees and commissions receivable as a result of growth in added-value current accounts and card services were more than offset by lower creditor insurance commissions and the impact of changes in product design leading to a greater proportion of earnings being recognised as net interest income rather than other income.

Operating expenses were £63 million, or 2 per cent, higher at £2,611 million in 2008 compared with £2,548 million in 2007. The Group had continued to benefit from the recent investment in reducing the levels of administration and processing work carried out in branches. This had enabled the Group to increase its focus on meeting the needs of its customers and had supported further improved productivity in the branch network sales effort. These initiatives supported a further improvement in the retail banking cost:income ratio to 44.4 per cent from 46.4 per cent in 2007.

The impairment charge on loans and advances of £1,472 million in 2008 was £248 million, or 20 per cent, higher than the £1,224 million impairment charge in 2007. The charge in respect of personal loans and overdrafts was £100 million, or 15 per cent, higher at £779 million compared to £679 million in 2007 and represented 5.73 per cent of average lending, compared to 5.32 per cent in 2007; and the charge in respect of card balances was £1 million lower at £526 million compared with £527 million in 2007. The impairment charge in Mortgages was £167 million, compared to £18 million in 2007, or 17 basis points of average mortgage lending. The most significant factors in the increase in the mortgage impairment charge during 2008 were the fall in the house price index and the deterioration in economic conditions in the UK.

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INSURANCE AND INVESTMENTS

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

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

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

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

	2008 £m	2007 £m
Net interest income	(62)	(106)
Other income	1,749	1,741
Total income	1,687	1,635
Insurance claims	(193)	(302)
Total income, net of insurance claims	1,494	1,333
Operating expenses	(591)	(611)
Trading surplus	903	722
Impairment	(2)	
Profit before tax, excluding insurance grossing	901	722
Insurance grossing adjustment[1]	10	26
Profit before tax	911	748

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

Analysis by area of business of profit before tax	2008 £m	2007 £m
Life, pensions and OEICs	635	597
General insurance	234	110
Scottish Widows Investment Partnership	42	41
Profit before tax	911	748

Profit before tax from the Group s Insurance and Investments business was £163 million, or 22 per cent, higher at £911 million in 2008 compared to £748 million in 2007 for the reasons discussed below.

Net interest income improved by £44 million to a net expense of £62 million in 2008 compared to a net expense of £106 million in 2007.

Other income was £8 million higher at £1,749 million in 2008 compared to £1,741 million in 2007.

Other income from Life, pensions and OEICs was flat as growth in new business profit, reflecting sales growth in insurance-accounted products, was offset by reduced existing business profits principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets.

Other income from Scottish Widows Investment Partnership was £13 million lower; but other income from general insurance was £21 million, or 4 per cent, higher at £582 million in 2008 compared to £561 million in 2007. Insurance broking commissions receivable were £99 million, or 15 per cent, lower at £549 million in 2008 compared to £648 million in 2007; home insurance commissions were flat but creditor commissions fell in line with reduced new loan volumes. Underwriting income, net of reinsurance, was £21 million, or 4 per cent, higher at £612 million in 2008 compared to £591 million in 2007 and fees and commissions payable were £87 million, or 13 per cent, lower at £605 million in 2008 compared to £692 million in 2007.

Operating expenses were £20 million, or 3 per cent, lower at £591 million in 2008 compared to £611 million in 2007. A decrease in professional and other fees related to project work was partly offset by increased staff costs.

The performances of the life, pensions and OEICs business and the general insurance business are discussed separately below, on pages 46 and 47.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LIFE, PENSIONS AND OEICS

The table below shows the Present Value of New Business Premiums (PVNBP) which is the measure of new business premiums for the life and pensions business and OEIC sales that management monitors because it provides an indication of both the performance and the profitability of the business this is calculated as the value of single premiums plus the discounted present value of future expected regular premiums. There are three main distribution channels for the sale of the Group s life, pension and OEIC products and the tables below show the relative importance of each.

Present value of new business premiums (PVNBP)	2008 £m	2007 £m
Life and pensions:		
Protection	997	960
Savings and investments	437	913
Individual pensions	2,125	2,073
Corporate and other pensions	2,482	2,141
Retirement income	939	1,044
Managed fund business	217	