Effective risk management, governance and control

Managing risk effectively is important for any bank and fundamental to our strategy. We are now a more efficient, low risk, UK focused retail and commercial bank. This has been achieved by maintaining a conservative business model which embodies a risk culture founded on a prudent appetite for risk.

Our approach to risk is founded on an effective control framework and a strong risk management culture which guides how our employees approach their work, the way they behave and the decisions they make. The amount and type of risk that we are prepared to seek, accept or tolerate, otherwise known as risk appetite, works in tandem with our strategy and is approved by the Board. Our risk appetite is then embedded within policies, authorities and limits across the Group.

Risk as a strategic differentiator

The Group strategy and risk appetite were developed together to ensure one informed the other in creating a strategy that delivers on becoming the best bank for our customers whilst helping Britain prosper and creating sustainable growth over time.

Risks are identified, managed and mitigated using our Risk Management Framework (see page 41). The principal risks we face, which could significantly impact the delivery of our strategy, are discussed on pages 133 to 196.

We believe effective risk management can be a strategic differentiator, in particular:

Sustainable growth
The role of risk is to support the business in delivering sustainable growth, which is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture across the Group.

Conservative approach to risk
We have a fully embedded conservative approach to, and prudent appetite for, risk with risk culture and appetite driven from the top.

Strong control framework
This framework is the foundation for the delivery of effective risk management as it ensures appropriate engagement in developing risk appetite and that business units operate within approved parameters.

Effective risk analysis, management and reporting
This identifies opportunities as well as risks and ensures risks are managed appropriately and consistently with strategy. Our principal risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This enables us to understand the risk in the business at both an individual risk type and aggregate portfolio level.

Business focus and accountability
Managing risk effectively is a key focus and is one of the five criteria within the Group Balanced Scorecard on which business areas and individual performance are judged. Our approach to risk means that businesses remain accountable for risk but a strong and independent risk function also helps ensure adherence to the Group's risk and control frameworks. Continued investment in risk systems and processes will also help differentiate our risk management approach.

123 More on Risk management

Achievements in 2013

Impairment
Our impairment charge improved by 47 per cent to £3,004 million, mainly driven by the reduction in non-core assets and the sustained improvement in Group asset quality.

Complaints
During 2013 banking complaints fell to 1.0 per 1,000 accounts (excluding PPI), compared with 1.5 at the end of 2011, and 2.4 at the start of 2010. Our 2014 reduction target was met and exceeded by September 2013.

Loan to deposit ratio
Our funding position remains strong with an improved loan to deposit ratio of 113 per cent, from 121 per cent at 31 December 2012. The core loan to deposit ratio fell to 100 per cent from 101 per cent at 31 December 2012.

Credit ratings
Credit ratings reflected the progress the Group had made on delivery of its strategy. During 2013 both Fitch and Standard & Poor's upgraded Lloyds Bank's standalone rating to bbb+, therefore affirming its long-term credit rating at A.

Improved capital position
Our common equity tier 1 (CET1) capital position has continued to build to 10.3 per cent on a pro forma fully loaded CRD IV basis, increasing by 2.2 per cent in the year, in line with our capital generative strategy.

Non-core asset reduction
We made substantial capital accretive non-core asset reductions during the year and, together with additional sales announced in October, our full year 2014 target of less than £70 billion of non-core assets was achieved by Q3 2013. Our year end position of £63.5 billion is ahead of plan.

State aid commitments
In line with strengthening the balance sheet, we continued our commitment to reduce our assets and met our target in December 2012, two years ahead of the mandated completion date. In May 2013, we received formal confirmation from the European Commission that we were released from this commitment.

Risk transformation
The Risk Transformation Programme has driven the clarity on where risk allocates transformational investment funding in order to deliver the most efficient and effective returns for the Group. This has ensured that the investments made deliver the benefits required and underpin the Group's targeted objective of sustainable growth.

Priorities for 2014

Deliver the strategic plan
Underpin the Group's strategy to be the best bank for customers and support sustainable growth in the UK economy.

Customer focus
Put our customers at the heart of our business through a clear conduct led approach and a strong understanding of all our stakeholders, supported by the codes of responsibility, applied to both current activities and historic legacy issues.

Operational agility
Evolve risk into an agile, flexible function that supports the business in its next phase of growth with effective working across the Group.

RISK OVERVIEW

Risk governance

Risk management strategy and risk appetite are developed and reviewed in tandem with Group strategy. The Group uses an enterprise-wide risk management framework to ensure a robust and consistent approach to risk management is applied across all business areas and all risk types in order to drive improvements in its risk profile in line with risk appetite.

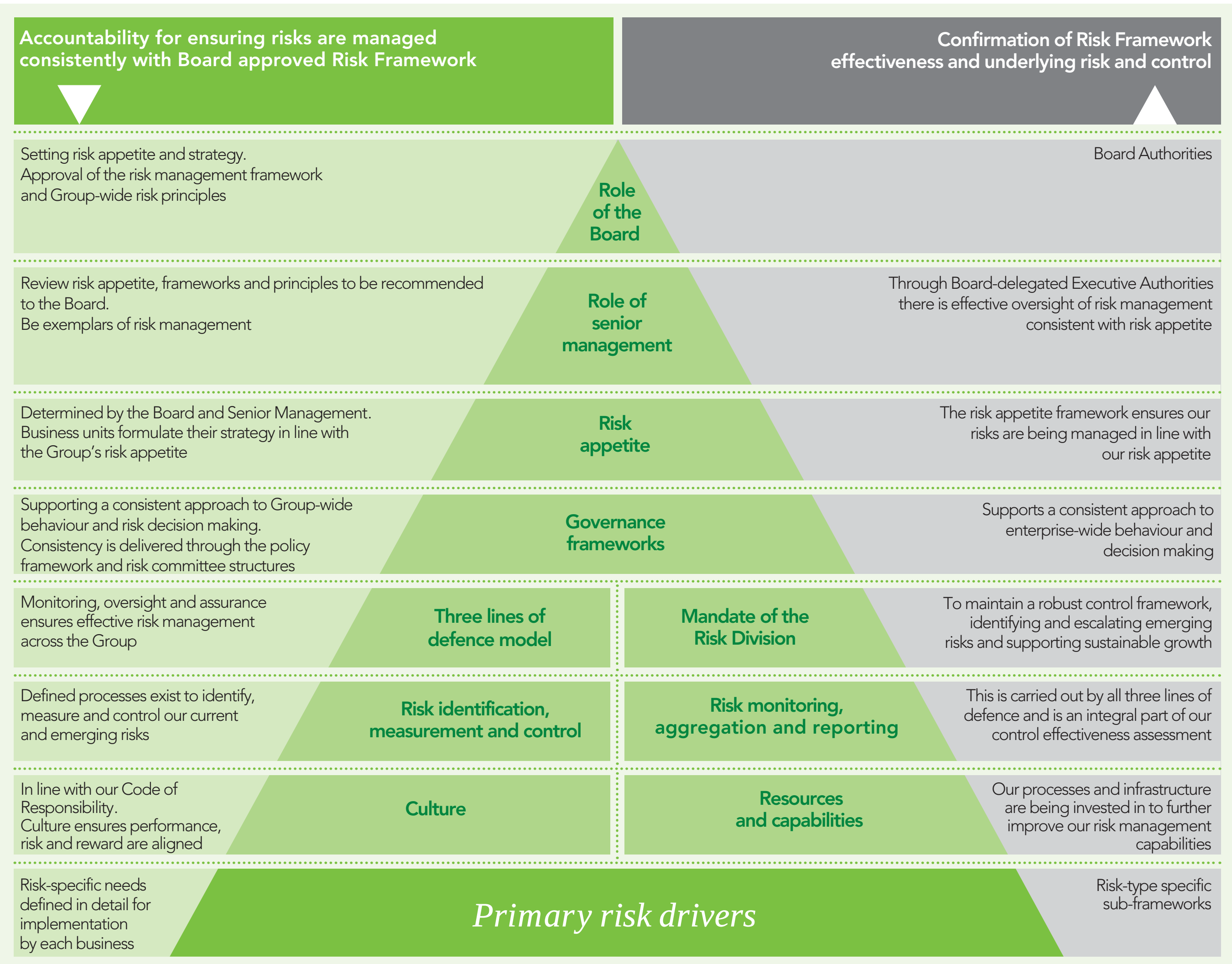
The framework articulates individual and collective accountabilities for risk management, risk oversight and risk assurance and supports the discharge of responsibilities to customers, shareholders and regulators. It establishes a common risk language which assigns risks to which the Group is exposed into categories which are used consistently to support risk aggregation and reporting. It will evolve and be periodically updated to reflect any changes in the nature of our business and the external environment.

The framework outlines the key risk management activities undertaken consistently across the Group for all types of risk.

Governance is maintained through delegation of authority from the Board, down through the management hierarchy, supported by a committee based structure designed to ensure that our risk appetite, policies, procedures, controls and reporting are fully in line with regulations, law, corporate governance and industry good-practice.

Our approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions. Board-level engagement, coupled with the direct involvement of senior management in Group-wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated where required. The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management. A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management. Performance is optimised by allowing business units to operate within approved parameters.

129 More on risk governance



RISK OVERVIEW

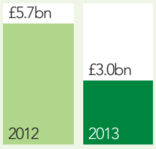
The most significant risks faced by the Group which could impact on the success of delivering against the Group's strategic objectives together with key mitigating actions are outlined below.

Principal risks	Key mitigating actions
Credit risk As a provider of credit facilities to personal and commercial customers, together with financial institutions and sovereigns, any adverse changes in the economic and market environment we operate in, or the credit quality and/or behaviour of our borrowers and counterparties would reduce the value of our assets and increase our write-downs and allowances for impairment losses, adversely impacting profitability.	- Credit policy incorporating prudent lending criteria aligned with the Board approved risk appetite to effectively manage credit risk. - Clearly defined levels of authority ensure we lend appropriately and responsibly with separation of origination and sanctioning activities. - Robust credit processes and controls including well-established committees to ensure distressed and impaired loans are identified, considered and controlled with independent credit risk assurance.
Conduct risk As a major financial services provider we face significant conduct risk, including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; and exhibiting behaviours which do not meet market or regulatory standards.	- Customer focused conduct strategy implemented to ensure customers are at the heart of everything we do. - Product approval, review processes and outcome testing supported by conduct management information. - Clearer customer accountabilities for colleagues, including rewards with customer-centric metrics. - Learn from past mistakes, including root cause analysis.
Market risk We face a number of key market risks including interest rate risk across the Banking and Insurance businesses. However, our most significant market risk is from the Defined Benefit Pension Schemes where asset and liability movements impact on our capital position.	- A rates hedging programme is in place to reduce liability risk. - Board approved pensions risk appetite covering interest rate, credit spreads and equity risks. - Credit assets and alternative assets are being purchased by the pension schemes as equities are sold. - Stress and scenario testing.
Operational risk We face a number of key operational risks including fraud losses and failings in our customer processes. The availability, resilience and security of our core IT systems is the most significant.	- Continually review IT system architecture to ensure systems are resilient, readily available for our customers and secure from cyber attack. - Implement actions from IT resilience review conducted in 2013 to reflect enhanced demands on IT, both in terms of customer and regulator expectations.
Funding and liquidity risk Our funding and liquidity position is supported by a significant and stable customer deposit base. However, a deterioration in either our or the UK's credit rating or a sudden and significant withdrawal of customer deposits would adversely impact our funding and liquidity position.	- Hold a large pool of liquid primary assets to meet cash and collateral outflows. - Maintain a further large pool of secondary assets which can be used to access Central Bank liquidity facilities. - Stress test the Group's liquidity position against a range of scenarios.
Capital risk Our future capital position is potentially at risk from adverse financial performance and the introduction of higher capital requirements for distinct risks, sectors or as a consequence of a specific UK regulatory requirement. For example in 2013, the PRA introduced significant additional capital requirements on an adjusted basis that major UK banks are required to meet.	- Close monitoring of actual capital ratios to ensure that we comply with current regulatory capital requirements and are well positioned to meet future requirements. - Internal stress testing results to evidence sufficient levels of capital adequacy for the Group under various scenarios. - We can accumulate additional capital in a variety of ways including raising equity via a rights issue or debt exchange and by raising tier 1 and tier 2 capital.
Regulatory risk Due to the nature of the industry we operate in we have to comply with a complex and demanding regulatory change agenda. Regulatory initiatives we have been working on in 2013 include CRD IV, Mortgage Market Review, Dodd-Frank and Foreign Account Tax Compliance Act 2010. The sanctions for failing to comply far outweigh the costs of implementation.	- The Legal, Regulatory and Mandatory Change Committee ensures we drive forward activity to develop plans for regulatory changes and track progress against those plans. - Continued investment in our people, processes and IT systems is enabling us to meet our regulatory commitments.
State aid HM Treasury currently holds 32.7 per cent of the Group's share capital. We continue to operate without government interference in day-to-day management decisions, however there is a risk that a change in government priorities could result in the current framework agreement being replaced, leading to interference in the operations of the Group. Failure to meet the EU State aid commitments arising from this government support could lead to sanctions.	- Most EU State aid commitments now met with the divestment of the rebranded (TSB) retail banking business outstanding. - Now progressing the divestment of TSB through an Initial Public Offering subject to regulatory and European Commission approval, to ensure best value for our shareholders and certainty for our customers and colleagues. - The divested business, rebranded TSB, has operated as a separate business within Lloyds Banking Group since September 2013.

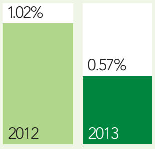
RISK OVERVIEW

Key risk indicators

Impairment charge

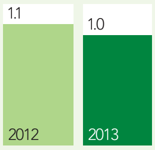


Asset quality ratio[1]



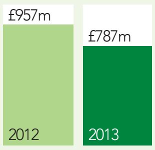
Commentary
Through non-core asset reduction and effective risk management of both existing and new business, we have seen sustained improvements in credit quality and reduction in impairments.

Banking complaints per 1,000 accounts[1] (excl. PPI)



Commentary
We are continuing our journey to embed the conduct strategy and be the industry leader for complaints performance.

Pensions deficit

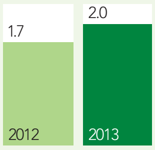


Commentary
Volatility in the Defined Benefit Pension Schemes is reducing as we target rates hedging and equity sales.

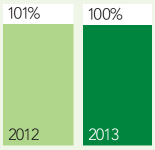
Availability of core systems

Commentary
Through effective control activities interruptions to customer service and operational losses for 2013 have remained within the Board approved appetite limits.

Primary liquidity/ wholesale funding <1 yr maturity



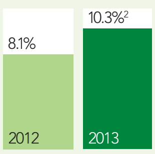
Core loan to deposit ratio[1]



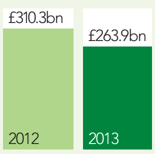
Commentary
The primary and secondary liquidity assets provide a substantial buffer in the event of an extended market dislocation.

The Group is now in a position where the core loan book is fully funded by core deposits.

CRD IV fully loaded CET1 ratio[1]

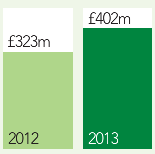


Risk-weighted assets (prevailing rules)



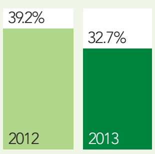
Commentary
Significant progress has been made in strengthening the balance sheet and capital position through our strongly capital generative strategy.

Legal, regulatory and mandatory investment spend



Commentary
We continue to build constructive relationships with our regulators in order to effectively manage the regulatory change agenda.

Government shareholding



Commentary
We continue to work closely with the European Commission, HM Treasury, PRA, FCA and the Monitoring Trustee appointed by the European Commission to ensure the successful implementation of the Restructuring Plan and mitigate customer impact.

Future focus

- Continue to support the UK economy through appropriate lending to SMEs and first-time buyers.

133 More on credit risk

- Continued reduction in complaint levels and improvements in complaints handling.

163 More on conduct risk

- Continue to effectively manage the Defined Benefit Pension Scheme to secure pensions provisions to members and minimise the impact on the Group.

164 More on market risk

- Increased investment in IT resilience.
- Risk appetite monitoring for critical business processes.

169 More on operational risk

- Continue to meet all current regulatory ratios and ensure we meet all future regulatory ratios.
- Further reduction of the loan to deposit ratio.

171 More on funding and liquidity risk

- Implement remaining non-core run-off and disposals to be net capital accretive.
- Expect, prior to any dividend, to generate fully loaded CET1 capital of around 2.5 percentage points over the next 2 years.

178 More on capital risk

- Ongoing constructive engagement with regulators.
- Continued compliance with the regulatory change agenda.

192 More on regulatory risk

- TSB will be divested through an Initial Public Offering, subject to regulatory and European Commission approval.
- Continue to support the government in the process of returning the Group back to private ownership.

[1] These key risk indicators are also key performance indicators (KPIs).
[2] Pro forma basis.