Risk overview
Effective risk management and control

As a Group, managing risk effectively is fundamental to our strategy and to operating successfully. We are a simple, low risk, UK focused bank with a culture founded on a prudent through the cycle risk appetite.

A strong risk management culture is crucial for sustainable growth and within Lloyds it is at the heart of everything we do.

Our approach to risk is founded on an effective control framework, which guides how our colleagues work, behave and the decisions they make. Risk appetite – the amount and type of risk we are prepared to seek, accept or tolerate – is approved by the Board and embedded in policies, authorities and limits across the Group.

Our prudent risk culture and appetite, along with close collaboration between Risk division and the business, supports effective decision making and has enabled us to continue to deliver against our strategic priorities in 2017, simplifying and strengthening the business whilst growing in targeted areas. We have created a strong foundation to enable this progress, ensuring we react appropriately to the ever changing macroeconomic and regulatory environment.

Risk as a strategic differentiator

Group strategy and risk appetite are developed together to ensure one informs the other to deliver on our purpose to help Britain prosper whilst becoming the best bank for customers, colleagues and shareholders.

Risks are identified, managed and mitigated using our comprehensive Risk Management Framework (see below), and our well articulated risk appetite provides a clear framework for effective decision making. The principal risks we face, which could significantly impact the delivery of our strategy, are discussed on pages 34–37.

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

Prudent approach to risk
Implementing a prudent approach to risk across the Group and embedding a strong risk culture ensures alignment to our strategy.

Strong control framework
The Group's Risk Management Framework is the foundation for the delivery of effective risk control and ensures that the Group risk appetite is continually developed and adhered to.

Business focus and accountability
Effective risk management is a key focus and is included in key performance measures against which business units are assessed. Business units in the first line of defence are accountable for risk with oversight from a strong and independent, second line of defence Risk division.

Effective risk analysis, management and reporting
Continuing to deliver regular close monitoring and stringent reporting to all levels of management and the Board ensures appetite limits are maintained and subject to stressed analysis at a risk type and portfolio level.

Sustainable growth
Embedding a risk culture that ensures proactive support and constructive challenge takes place across the business is important for delivering sustainable growth.

Our risk management framework

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

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

Risk considerations

The potential risks and impacts arising from the external environment are outlined below. They are grouped using the same classification as on pages 8–9, with links to our principal risks and strategic priorities. For information on how we manage our emerging risks, see page 110.

Economy

Risk and potential impact

Economic headwinds such as rising inflation could impact households' disposable income and businesses' profitability, impairing customers' ability to repay their borrowing, and potentially hindering sustainable growth.

The impact of EU exit on our portfolios remains uncertain. Operational changes are likely to be limited given our UK focus but the impact on the UK economy may affect business performance.

We consider an array of scenarios as part of our operating plan and stress testing exercises, to identify and implement appropriate mitigating actions.

Link to principal risks

Credit
Operational
Insurance underwriting
Capital
Funding and liquidity
Market

Link to strategic priorities

Maximising the Group's capabilities

Regulation and legal

Risk and potential impact

The financial services industry continues to experience significant legislative and regulatory change and interpretation giving rise to uncertainty surrounding the nature, scale and complexity of implementation requirements.

This has the potential to impact, for example, the resource and investment available to allocate to the Group's strategic priorities.

The Group has a proven track record in implementing complex legal and regulatory programmes and will continue to manage any potential impact by remaining actively engaged with governmental bodies, regulatory authorities and industry associations.

Link to principal risks

Credit
Regulatory and legal
Capital
Funding and liquidity
Market

Link to strategic priorities

Delivering a leading customer experience

Customer

Risk and potential impact

The availability and delivery of services through digital channels is becoming increasingly important for customer satisfaction. Accelerated change in customer behaviour and expectations may require increased agility to accommodate the pace and scale of change and could lead to customer detriment if this change is poorly executed.

The Group will continue to focus on change execution whilst keeping pace with developments to meet new and evolving customer needs.

Link to principal risks

Regulatory and legal
Conduct
Operational

Link to strategic priorities

Delivering a leading customer experience

Technology

Risk and potential impact

New technologies such as public cloud and artificial intelligence along with growing interconnectivity between the Group, customers, and third parties create new risks.

Increasing capabilities of cyber-attackers and higher volumes of connected devices increases the potential for cyber-enabled fraud and other crime, including attacks that could disrupt service for customers.

We continue to optimise our approach to operational resilience by enhancing systems that support the Group's critical business processes, evolving controls within new technologies and channels, and making significant investment to improve data privacy, including the security of data.

Link to principal risks

Conduct
Operational

Link to strategic priorities

Delivering a leading customer experience
Digitising the Group

Competition

Risk and potential impact

Technological change is driving an increase in the number, and changing the nature of competitors in the UK financial services industry, opening up opportunities for consumers even as levels of regulatory focus rise.

We must ensure that an unexpectedly fast pace of change, which may accelerate customer disintermediation, does not lead to our involvement in anti-competitive practices, or prevent certain customer groups from having equal access to our products and services.

We will continue to address this through innovation and developing new products that respond to market trends and meet customer changing needs.

Link to principal risks

Regulatory and legal
Conduct
Operational
People

Link to strategic priorities

Delivering a leading customer experience
Maximising the Group's capabilities

The links shown here between these five factors and our principal risks and strategic priorities are not an exhaustive list.

Find further discussion on the impact of these factors on our business on **pages 8–9**

Risk overview continued

Principal risks

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

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

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

Principal risks and uncertainties are reviewed and reported regularly. This year we have added a new principal risk, model risk, to reflect the Group's increasing use of analytics and models to make decisions.

Credit

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

Example

- Adverse impact on profitability due to an increase in impairment losses, write downs and/or decrease in asset valuations which can occur for a number of reasons, including adverse changes in the economic, geopolitical and market environment. For example, low interest rates have helped customer affordability, but there is a risk of increased defaults as interest rates rise.

Key mitigating actions

- Credit policy, incorporating prudent lending criteria, aligned with Board approved risk appetite, to effectively manage risk.
- Robust risk assessment and credit sanctioning to ensure we lend appropriately and responsibly.
- Extensive and thorough credit processes and controls to ensure effective risk identification, management and oversight.
- Effective, well-established governance process supported by independent credit risk assurance.
- Early identification of signs of stress leading to prompt action in engaging the customer.

Key risk indicators

Impairment charge
£795m
2016: £645m

Impaired assets
£7,841m
2016: £8,495m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

We seek to support sustainable growth in our targeted segments. We have a conservative and well balanced credit portfolio, managed through the economic cycle and supported by strong credit portfolio management.

We are committed to better addressing our customers' banking needs through consistent, fair and responsible credit risk decisions, aligned to customers' circumstances, whilst staying within prudent risk appetite.

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

Read more on **pages 116–133**

Regulatory and legal

The risks of changing legislation, regulation, policies, voluntary codes of practice and their interpretation in the markets in which we operate may have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

Examples

- Increased regulatory oversight and prudential regulatory requirements.
- Increased legislative requirements, such as ring-fencing legislation, Payment Services Directive 2 (PSD2), Open Banking and General Data Protection Regulation (GDPR).

Key mitigating actions

- Ensure we develop comprehensive plans for delivery of all legal and regulatory changes and track their progress. Group-wide projects implemented to address significant impacts.
- Continued investment in people, processes, training and IT to assess impact and help meet our legal and regulatory commitments.
- Engage with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations.

Key risk indicators

Mandatory, legal and regulatory investment spend
£886m
2016: £555m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

We are committed to operating sustainably and responsibly, and commit significant resource and expense to ensure we meet our legal and regulatory obligations.

We respond as appropriate to impending legislation, regulation and associated consultations and participate in industry bodies. We continue to be subject to significant ongoing and new legislation, regulation and court proceedings.

Read more on **page 133**

Conduct

Conduct risk can arise from a number of areas including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; failing to promote effective competition in the interest of customers; and exhibiting behaviours which could impact on the integrity of the market or undermine wider regulatory standards.

Example

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

Key mitigating actions

- Conduct risk appetite metrics provide a granular view of how our products and services are performing for customers.
- Product approval, continuous product review processes and customer outcome testing (across products and services) supported by conduct management information.
- Learning from past mistakes through root cause analysis and clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics.
- Further enhancements and embedding of our framework to support customers in vulnerable circumstances.

Key risk indicators

Conduct risk appetite metric performance-Group

92.3%

2016: 92.1%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

As we transform our business, minimising conduct risk is critical to achieving our strategic goals and meeting regulatory standards.

Our focus on embedding a customer-centric culture and delivering good outcomes through good conduct is subject to robust review by the Group Customer First Committee. This supports our vision of being the best bank for customers, enabling the delivery of a leading customer experience through effective root cause analysis and learning from customer feedback.

Read more on **page 134**

Operational

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

Example

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

Key mitigating actions

- Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems, and to ensure effective third party assurance.
- Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis.
- Significant investment in compliance with GDPR and Basel Committee on Banking Supervision standards.
- Working with industry bodies and law enforcement agencies to identify and combat fraud and money laundering.

Key risk indicators

Availability of core systems

99.98%

2016: 99.97%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

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

Read more on **pages 135–136**

People

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

Example

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

Key mitigating actions

- Focused action to attract, retain and develop high calibre people. Delivering initiatives which reinforce behaviours to generate the best outcomes for customers and colleagues.
- Managing organisational capability and capacity to ensure there are the right skills and resources to meet our customers' needs.
- Effective remuneration arrangements to promote appropriate colleague behaviours and meet regulatory expectations.

Key risk indicators

Best bank for customers index

80%

2016: 77%

Alignment to strategic priorities and future focus

Transforming ways of working

Continued regulatory change relating to personal accountability and remuneration rules could affect the Group's ability to attract and retain the calibre of colleagues required to meet our changing customer needs. We will continue to invest in the development of colleague capabilities and agile working practices in order to deliver a leading customer experience, and to respond quickly to the rapidly evolving change in customers' decision making in an increasingly digital marketplace.

Read more on **page 136**

Risk overview continued

Insurance underwriting

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

Example

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

Key mitigating actions

- Processes for underwriting, claims management, pricing and product design seek to control exposure. Longevity and bulk pricing experts support the bulk annuity proposition.
- The merits of longevity risk transfer and hedging solutions are regularly reviewed for the Insurance business.
- Property insurance exposures are mitigated by a broad reinsurance programme.

Key risk indicators

Insurance (Life and Pensions) present value of new business premiums	General Insurance underwritten total gross written premiums
£9,951m	£733m
2016: £8,919m	2016: £831m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

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

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

Read more on page 137

Capital

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

Example

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

Key mitigating actions

- A comprehensive capital management framework that includes setting of capital risk appetite and dividend policy.
- Close monitoring of capital and leverage ratios to ensure we meet regulatory requirements and risk appetite.
- Comprehensive stress testing analyses to evidence capital adequacy under various adverse scenarios.

Key risk indicators

Common equity tier 1 ratio[1,2]	UK leverage ratio[1,3]
13.9%	5.4%
2016: 13.0%	2016: 5.3%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

Ensuring we hold an appropriate level of capital to maintain financial resilience and market confidence, underpins our strategic objectives of supporting the UK economy and growth in targeted segments.

1 Pro forma.

2 CET1 ratio after ordinary dividends and share buyback. 2016 adjusted for MBNA.

3 Calculated in accordance with the UK Leverage Ratio Framework which requires qualifying central bank claims to be excluded from the leverage exposure measure.

Read more on pages 137–144

Funding and liquidity

The risk that we have insufficient financial resources to meet our commitments as they fall due.

Example

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

Key mitigating actions

- Holding liquid assets to cover potential cash and collateral outflows and to meet regulatory requirements. In addition, maintaining a further pool of assets that can be used to access central bank liquidity facilities.
- Undertaking daily monitoring against a number of market and Group-specific early warning indicators.
- Maintaining a contingency funding plan detailing actions and strategies available in stressed conditions.

Key risk indicators

LCR eligible assets	Loan to deposit ratio
£121bn	110%
2016: £121bn	2016: 109%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

We maintain a strong funding position in line with our low risk strategy and the loan to deposit ratio remains within our target range. Our funding position allows the Group to grow targeted business segments and better address our customers' needs.

Read more on pages 144–149

Governance

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from meeting the requirements to ring-fence core UK financial services and activities from January 2019 and further requirements under the Senior Manager & Certification Regime (SM&CR).

Examples

- Inadequate or complex governance arrangements to address ring-fencing requirements could result in a weaker control environment, delays in decision making and lack of clear accountability.
- Non-compliance with or breaches of SM&CR requirements could result in lack of clear accountability and legal and regulatory consequences.

Key mitigating actions

- Leveraging our considerable change experience to meet ring-fencing requirements before the regulatory deadlines, and the continuing evolution of SM&CR.
- Programme in place to address ring-fencing. In close and regular contact with regulators to develop and deploy our planned operating and legal structure.
- Evolving risk and governance arrangements to continue to be appropriate to comply with regulatory objectives.

Key risk indicators
N/A

Alignment to strategic priorities and future focus

Delivering a leading customer experience

Ring-fencing will ensure we become safer and continue to deliver a leading customer experience by providing further protection to core retail and SME deposits, increasing transparency of our operations and facilitating the options available in resolution.

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

Read more on page 150

Market

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

Examples

- Earnings are impacted by our ability to forecast and model customer behaviour accurately and establish appropriate hedging strategies.
- The Insurance business is exposed indirectly to equity risk through the value of future management charges on policyholder funds. Credit spread risk within the Insurance business primarily arises from bonds and loans used to back annuities.
- Narrowing credit spreads will increase the cost of pension scheme benefits.

Key mitigating actions

- Structural hedge programmes implemented to manage liability margins and margin compression.
- Equity and credit spread risks are closely monitored and, where appropriate, asset and liability matching is undertaken.
- The Group's DB pension schemes have increased their credit allocation and hedged against nominal rate and inflation movements.

Key risk indicators
IAS19 Pension surplus
£509m
2016: £(244)m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

We actively manage our exposure to movements in market rates, to drive lower volatility earnings and offer a comprehensive customer proposition with hedging strategies to support strategic aims. Mitigating actions are implemented to reduce the impact of market movements, resulting in a more stable capital position. Effective interest rate and inflation hedging has kept volatility in the Group's DB pension schemes low and helped to return the schemes to IAS19 surplus in 2017. This allows us to more efficiently utilise available capital resources to better enable the Group to maximise its capabilities.

Read more on pages 151–156

Model NEW

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

Examples

Examples of the consequences of inadequate models include:

- Inappropriate levels of capital or impairments.
- Inappropriate credit or pricing decisions.
- Adverse impacts on funding or liquidity, or the Group's earnings and profits.

Key mitigating actions

A comprehensive model risk management framework including:

- Defined roles and responsibilities, with clear ownership and accountability.
- Principles regarding the requirements of data integrity, development, validation, implementation and ongoing maintenance.
- Regular model monitoring.
- Independent review of models.
- Periodic validation and re-approval of models.

Key risk indicators
N/A

Alignment to strategic priorities and future focus

Digitising the Group

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

Read more on page 156