

HBOS plc

Report and Accounts 2016

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Member of Lloyds Banking Group

HBOS plc
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HBOS plc
Strategic report

Principal activities

HBOS plc (the Company) and its subsidiary undertakings (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

The Group's revenue is earned through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and capital market products to commercial, corporate and asset finance customers; and private banking.

Business review

During the year ended 31 December 2016, the Group recorded a profit before tax of £3,804 million, an increase of £1,064 million, or 39 per cent, compared with a profit before tax in 2015 of £2,740 million. The result in 2016 included provisions in respect of redress to customers (together with the related administrative costs) associated with both past sales of Payment Protection Insurance and other matters of £635 million compared to a charge of £1,421 million in the year ended 31 December 2015. Excluding these charges from both years, profit before tax was £278 million, or 7 per cent, higher at £4,439 million in the year ended 31 December 2016 compared to £4,161 million in the previous year.

Total income increased by £291 million, or 4 per cent, to £7,676 million in 2016 compared with £7,385 million in 2015, comprising a £636 million increase in other income partly offset by a decrease of £345 million in net interest income.

Net interest income was £6,361 million in 2016; a decrease of £345 million, or 5 per cent compared to £6,706 million in 2015; net interest margin was maintained.

Other income was £636 million higher at £1,315 million in 2016 compared to £679 million in 2015. Fee and commission income was £19 million, or 2 per cent, lower at £787 million compared to £806 million in 2015. Fee and commission expense increased by £37 million, or 11 per cent, to £360 million compared with £323 million in 2015. The decrease in net fee and commission income largely reflects lower levels of current account and credit and debit card fees as well as reduced income from commercial banking activities. Net trading income increased by £128 million to £280 million in 2016 compared to £152 million in 2015. Other operating income was £564 million higher at £608 million in 2016 compared with £44 million in 2015, largely due to a gain of £435 million arising on a restructuring of capital instruments within the Lloyds Banking Group.

Operating expenses decreased by £786 million, or 18 per cent to £3,666 million in 2016 compared with £4,452 million in 2015; the main reason for the decrease being the £786 million reduction in charges for redress payments to customers in respect of PPI and other conduct related matters from £1,421 million in 2015 to £635 million in 2016. Excluding these charges from both years, operating expenses were flat at £3,031 million. Staff costs were £21 million, or 1 per cent, lower at £1,512 million in 2016 compared with £1,533 million in 2015; annual pay rises have been more than offset by the impact of headcount reductions resulting from the Group's rationalisation programmes, although there has been an increase in severance costs in relation to restructuring initiatives. Premises and equipment costs were £64 million or 25 per cent, lower at £196 million in 2016 compared with £260 million in 2015. Other expenses were £87 million higher at £1,151 million in 2016 compared with £1,064 million in 2015. Depreciation and amortisation costs were £172 million in 2016 compared to £174 million in 2015.

Impairment losses increased by £13 million, or 7 per cent, to £206 million in 2016 compared with £193 million in 2015. Impairment losses in respect of loans and advances to customers were £1 million higher at £216 million in 2016 compared with £215 million in 2015. There was a credit of £10 million in respect of undrawn commitments in 2016, compared to a credit of £26 million in 2015.

In 2016, the Group recorded a tax charge of £1,198 million compared to a tax charge of £729 million in 2015, an effective tax rate of 31 per cent, compared to the standard UK corporation tax rate of 20 per cent, principally as a result of the banking surcharge, restrictions on the deductibility of conduct provisions and the negative impact on the net deferred tax asset of the change in corporation tax rate.

Total assets were £8,276 million, or 2 per cent, higher at £344,278 million at 31 December 2016 compared to £336,002 million at 31 December 2015. Loans and advances to customers were £1,938 million, or 1 per cent, lower at £268,899 million at 31 December 2016 compared to £270,837 million at 31 December 2015; the continued reduction in the portfolio of assets which are outside of the Group's risk appetite and lower UK mortgage balances, as the Group concentrates on protecting margin in the current market, more than offset growth in European mortgage balances (in part due to exchange rate movements) and in other personal lending in the UK. Total liabilities were £8,922 million, or 3 per cent, higher at £329,443 million at 31 December 2016 compared to £320,521 million at 31 December 2015. Total equity was £646 million, or 4 per cent, lower at £14,835 million at 31 December 2016 compared to £15,481 million at 31 December 2015; this reflected a negative post-retirement defined benefit scheme remeasurement, profit for the year has been offset by dividends paid.

The Group's common equity tier 1 capital ratio increased to 12.7 per cent (31 December 2015: 11.1 per cent), principally as a result of the increase in retained earnings following the lower accrual for foreseeable dividends, partially offset by interim dividends paid during the year. The tier 1 capital ratio increased to 16.6 per cent (31 December 2015: 15.3 per cent) and the total capital ratio increased to 20.4 per cent (31 December 2015: 19.4 per cent) reflecting the increase in common equity tier 1 capital, partially offset by the annual reduction in the transitional limit applied to grandfathered instruments and the amortisation of dated tier 2 instruments.

Risk-weighted assets reduced by £546 million, or 1 per cent, to £78,608 million at 31 December 2016 compared to £79,154 million at 31 December 2015, largely relating to active portfolio management, offset in part by model updates related to UK mortgage portfolios and new lending.

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Future developments

Information about future developments is provided with the Principal risks and uncertainties section below.

Capital position at 31 December 2016

The Group's capital position applying CRD IV transitional rules at 31 December 2016 is set out in the following section.

Table 1.1 Capital-resources

	At 31 Dec 2016 £m	At 31 Dec 2015 £m
Capital resources (audited)		
Common equity tier 1		
Shareholders' equity per balance sheet	13,298	13,944
Adjustment to retained earnings for foreseeable dividends	(500)	(2,000)
Cash flow hedging reserve	(89)	(169)
Other adjustments	(10)	(8)
	12,699	11,767
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	(424)	(425)
Prudent valuation adjustment	(165)	(63)
Excess of expected losses over impairment provisions and value adjustments	(132)	(174)
Removal of defined benefit pension surplus	(69)	(540)
Securitisation deductions	(186)	(166)
Non-significant investments	(61)	(28)
Deferred tax assets	(1,678)	(1,606)
Common equity tier 1 capital	9,984	8,765
Additional tier 1		
Additional tier 1 instruments	3,314	3,617
Less: deductions from tier 1		
Non-significant investments	(272)	(300)
Total tier 1 capital	13,026	12,082
Tier 2		
Tier 2 instruments	3,206	3,534
Eligible provisions	321	322
Less: deductions from tier 2		
Non-significant investments	(512)	(566)
Total tier 2 capital	3,015	3,290
Total capital resources	16,041	15,372
Risk-weighted assets	78,608	79,154
Common equity tier 1 capital ratio	12.7%	11.1%
Tier 1 capital ratio	16.6%	15.3%
Total capital ratio	20.4%	19.4%

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Table 1.2: Risk-weighted assets (unaudited)

	2016 £m	2015 £m
Risk-weighted assets		
Foundation IRB Approach	7,626	10,456
Retail IRB Approach	40,295	37,626
Other IRB Approach	5,525	5,598
IRB Approach	53,446	53,680
Standardised Approach	8,184	8,674
Credit risk	61,630	62,354
Counterparty credit risk	1,574	1,785
Contributions to the default fund of a central counterparty	–	1
Credit valuation adjustment risk	242	313
Operational risk	12,256	11,958
Market risk	1,980	1,580
Underlying risk-weighted assets	77,682	77,991
Threshold risk-weighted assets	926	1,163
Total risk-weighted assets	78,608	79,154

Principal risks and uncertainties

The most significant risks faced by the Group which could impact the delivery of our long-term strategic objectives and our response, are detailed below.

Lloyds Banking Group has already considered many of the potential implications following the UK's vote to leave the European Union and the impact to its customers, colleagues and products as well as legal, regulatory, tax, finance and capital implications. Continued uncertainty surrounding the political and macroeconomic environment remains but the potential impacts of external factors have been considered in all principal risks and uncertainties to ensure any material uncertainties continue to be monitored and are appropriately mitigated.

Credit risk

Principal risks

The risk that customers and/or other counterparties with whom we have either lent money to or entered into a financial contract with, or other counterparties with whom we have contracted, fail to meet their financial obligations, resulting in loss to the Group. Adverse changes in the economic and market environment or the credit quality and/or behaviour of the Group's customers and counterparties could reduce the value of our assets and potentially increase write-downs and allowances for impairment losses, adversely impacting profitability.

Mitigating actions

Credit policy, incorporating prudent lending criteria, aligned with the Lloyds Banking Group 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.

Regulatory and legal risk

Principal risks

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

Mitigating actions

Ensure the Group develop comprehensive plans for delivery of all legal and regulatory changes and track their progress. Groupwide 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.

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Conduct risk

Principal risks

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; and exhibiting behaviours which do not meet market or regulatory standards.

Mitigating actions

Conduct risk appetite metrics provide a granular view on how our products and services are performing for customers.

Product approval, review processes and outcome testing 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.

The development of a refined framework for addressing thematic issues impacting customers in vulnerable circumstances.

Operational risk

Principal risks

Significant operational risks which may result in financial loss, disruption of services to customers and damage to the Group's reputation. These include the availability, resilience and security of core IT systems and the potential for failings in customer processes.

Mitigating actions

Continual review of the Group's IT environment to ensure that systems and processes can effectively support customers' requirements.

Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis.

Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems and responding to findings from third party industry testing.

People risk

Principal risks

Key people risks include the risk that the Group fails to maintain organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change.

Mitigating actions

Focused action on strategy 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.

Capital risk

Principal risks

The risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Mitigating actions

A comprehensive capital management framework that sets and monitors capital risk appetite, including dividend policy, appropriately.

Close monitoring of capital and leverage ratios to ensure we meet current and future regulatory requirements.

Comprehensive stress testing analysis to evidence capital adequacy under various adverse scenarios.

Funding and liquidity risk

Principal risks

The risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Mitigating actions

Holding liquid assets to meet potential cash and collateral outflows, regulatory requirements and maintaining a further pool of secondary assets that can be used to access central bank liquidity facilities.

Undertaking daily monitoring against a number of market and Lloyds Banking Group specific early warning indicators, maintaining a contingency funding plan detailing actions and strategies available in stressed conditions.

Governance risk

Principal risks

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from the requirement to improve the resolvability of Lloyds Banking Group and to ring-fence core UK financial services and activities from January 2019 and further requirements under the Senior Managers and Certification Regime (SM&CR) which come into force from March 2017.

Mitigating actions

Leveraging our considerable change experience to meet ring-fencing and resolution planning requirements and the continuing evolution of SM&CR.

Programme in place to address ring-fencing and resolution planning. In close and regular contact with regulators to develop plans for our anticipated operating and legal structure.

Evolving risk and governance arrangements that continue to be appropriate to comply with regulatory objectives.

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Strategic report

Market risk

Principal risks

The risk that the Group's capital or earnings profile is affected by adverse market movements, in particular interest rates and credit spreads in the Banking business, and credit spreads in the Group's Defined Benefit Pension Schemes.

Mitigating actions

Structural hedge programmes have been implemented to manage liability margins and margin compression, and the Group's exposure to Bank Base Rate.

Equity and credit spreads are closely monitored and, where appropriate, asset liability matching is undertaken to mitigate risk.

The Group's Defined Benefit Pension Schemes have increased their credit allocation and hedged against nominal rate/inflation movements.

Stress and scenario testing of the Group's risk exposures.

Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 45. The Group's approach to risk management including risk policies, risk appetite, measurement bases and sensitivities, in particular for credit risk, market risk and liquidity risk, is aligned to those of Lloyds Banking Group plc, the Company's ultimate parent. Further information can be found in the Lloyds Banking Group plc annual report.

The 2016 Strategic Report has been approved by the Board of Directors.

On behalf of the Board

Lord Blackwell
HBOS plc
20 March 2017



HBOS plc
Directors' report

Results

The consolidated income statement on page 14 shows a statutory profit before tax for the year ended 31 December 2016 of £3,804 million (year ended 31 December 2015: £2,740 million).

Dividends

During the year the Company paid interim dividends of £2,000 million and £610 million, a cumulative total of £2,610 million (2015: £11,500 million). The Directors have not recommended a final dividend for the year ended 31 December 2016 (2015: nil).

Post balance sheet events

Details of events since the balance sheet date are set out in note 48 on page 92.

Going concern

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered the principal risks and uncertainties and capital position set out in the strategic report on pages 2 to 6 and additionally have considered projections for the Group's capital and funding position. Accordingly, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts over the next 12 months, from the date of approval of the financial statements.

Directors

The names of the current Directors are shown on page 10. Changes to the composition of the Board since 1 January 2016 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
Stuart Sinclair	4 January 2016	
Dyfrig John		11 May 2016

Appointment and retirement of Directors

The appointment of Directors is governed by the Company's articles of association and the Companies Act 2006. The Company's articles of association may only be amended by a special resolution of the shareholders in a general meeting.

Directors' indemnities

The Directors of the Company, including the former Director who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deeds indemnify the Directors to the maximum extent permitted by law and remain in force for the duration of a Director's period of office. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Director appointed in 2016. In addition, Lloyds Banking Group plc had appropriate Directors' and Officers' liability insurance cover in place throughout 2016. Deeds for existing Directors are available for inspection at the Company's registered office.

Lloyds Banking Group plc has also granted deeds of indemnity by deed poll and by way of entering into individual deeds, which constitute 'qualifying third party indemnity provisions' to the Directors of the Group's subsidiary companies, including to former Directors who retired during the year and since the year end. Such deeds were in force during the financial year ended 31 December 2016 and remain in force as at the date of this report. Qualifying pension scheme indemnities have also been granted to the Trustees of Lloyds Banking Group's Pension Schemes, which were in force for the whole of the financial year and remain in force as at the date of this report.

Directors' interests

The Directors are also Directors of Lloyds Banking Group plc and their interests in shares in Lloyds Banking Group plc are shown in the report and accounts of that company.

Conflicts of interest

The Board has a comprehensive procedure for reviewing and, as permitted by the Companies Act 2016 and the Company's articles of association, approving actual and potential conflicts of interests. Directors have a continuing duty to notify the Chairman and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to the commitments of all Directors are reported to the Board and a register of potential conflicts and time commitments is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

Stuart Sinclair is Senior Independent Director at both QBE Insurance (Europe) Limited, a general insurance and reinsurance company, and Swinton Group Limited, an insurance broker for home and motor insurance. The Board has recognised that potential conflicts may arise in relation to his position at QBE Insurance and in relation to Swinton Group. The Board has authorised the potential conflicts and requires Mr Sinclair to recuse himself from discussions, should the need arise.

Branches, future developments and financial risk management objectives and policies

The Company provides a wide range of banking and financial services through branches and offices in the UK and overseas. Information regarding future developments and financial risk management objectives and policies of the Group in relation to the use of financial instruments that would otherwise be required to be disclosed in the Directors' report, and which is incorporated into this report by reference, can be found in the strategic report.

Share capital

Information about share capital is shown in note 34 on page 57. This information is incorporated into this report by reference.

The Company did not repurchase any of its shares during 2016 (2015: none). There are no restrictions on the transfer of shares in the Company other than set out in the articles of association and certain restrictions which may from time to time be imposed by law and regulations.

The Directors manage the business of the Company under the powers set out in the Companies Act 2006 and the Company's articles of association, these powers include those in relation to the issue or buy back of the Company's shares.

HBOS plc

Directors' report

Change of control

The Company is not party to any significant contracts that are subject to change of control provisions in the event of a takeover bid. There are no agreements between the Company and its Directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

Research and development activities

During the ordinary course of business the Company develops new products and services within the business units.

Employees

The Company, as part of Lloyds Banking Group, widens and promotes Inclusion & Diversity (I&D) through the Group Executive Committee, executive level I&D sponsors, quarterly I&D forum and I&D Operational committee, which oversees implementation of I&D strategy. During 2016, Lloyds Banking Group launched a new Group-wide 'everyone' campaign to explain the relevance and importance of inclusion to all colleagues, introduced a new 'Family Matters' network for parents and carers and re-launched the REACH (Race, Ethnicity and Cultural Heritage) network. Lloyds Banking Group became the first UK company to include gender dysphoria in its Private Medical Benefit provision and were ranked number one private sector employer in the Stonewall Top 100. Lloyds Banking Group was also named a Times Top 50 Employer for Women and Top 10 Employer for Working Families.

Lloyds Banking Group is committed to being a more disability confident employer. More than 5,000 colleagues disclosed a disability in the most recent colleague survey, and the Group is recognised as a leading employer for disabled people with cutting edge practices for customers and colleagues; in 2016 Lloyds Banking Group won a Business Disability SMART Award for the third year running for workplace adjustments processes and were highly commended for their colleague disability network. A range of programmes are available to support colleagues who become disabled or develop a long-term health condition, the workplace adjustments process, which includes physical equipment, has supported over 18,000 colleagues to date. Since 2002 Lloyds Banking Group have been running Personal Development and Career Development Programmes for disabled colleagues, 1,500 colleagues have completed this programme to date. Lloyds Banking Group aims to appoint the best person available into any role and to attract talented people from diverse backgrounds, encouraging and giving full and fair consideration to job applications from people with a disability, being unbiased in the assessment, selection, appointment, training and promotion of people.

Lloyds Banking Group offers a guaranteed interview scheme for candidates who declare a disability and meet the minimum requirements of the role, and continues to run a Disability Work Experience Programme in partnership with Remploy. This is one of the largest disability-focused work experience initiatives in the financial services sector. Lloyds Banking Group offers a competitive and fair reward package that supports its aims as a responsible business. After a detailed review in 2015 of the variable pay arrangements used to incentivise customer-facing colleagues, variable pay for colleagues in the Retail division is no longer linked to individual or branch level sales or product targets. To build on these changes, a single variable pay arrangement was introduced for these colleagues in 2016. Customer-facing colleagues in Retail are now incentivised by reference to balanced scorecard metrics with clearly identified performance descriptors, in line with the Lloyds Banking Group annual bonus plan approach. These changes ensure that colleagues are rewarded for action and behaviour which puts customers first. Lloyds Banking Group have recognition agreements with two trade unions, Accord and Unite, which collectively negotiate and consult on behalf of around 95 per cent of colleagues.

Lloyds Banking Group regularly provides colleagues with information on its performance and matters that concern their role, such as changes in the economic and regulatory environment, organisational changes and reward and remuneration. Colleagues are offered share schemes as part of wider incentive arrangements, to encourage shared ownership of the business.

Significant contracts

Details of related party transactions are set out in note 40.

Statement of directors' responsibilities

The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law, the Directors have prepared the Company and Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and the Group and of the profit or loss of the Company and the Group for that period. In preparing these financial statements, the Directors are required to: select suitable accounting policies and then apply them consistently; make judgements and accounting estimates that are reasonable and prudent; and state whether applicable IFRSs as adopted by the European Union have been followed.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on the website www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity in relation to the Company on that website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, who are in office as at the date of this report and whose names are shown on page 10 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position and the profit or loss of the Company and the Group; and
- the management report contained in the strategic report and the Directors' report includes a fair review of the development and performance of the business and the position of the Company and Group, together with a description of the principal risks and uncertainties faced by the Company and the Group.

The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for Shareholders to assess the Company's performance, business model and strategy. The Directors have also separately reviewed and approved the strategic report.

HBOS plc
Directors' report

Independent auditor and audit information

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware and each Director has taken all the steps that he or she ought to have taken as a Director to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

A resolution will be proposed at the 2017 annual general meeting to re-appoint PricewaterhouseCoopers LLP as auditor. The Company's Audit Committee is satisfied that the external auditor remains independent and effective.

On behalf of the Board

Malcolm Wood
Company Secretary
20 March 2017



HBOS plc
Registered in Scotland
Company Number SC218813

Directors

Lord Blackwell *Chairman*

António Horta-Osório *Executive Director and Group Chief Executive*

George Culmer *Executive Director and Chief Financial Officer*

Juan Colombás *Executive Director and Chief Risk Officer*

Alan Dickinson

Anita Frew

Simon Henry

Nick Luff

Deborah McWhinney

Nick Prettejohn

Stuart Sinclair

Anthony Watson CBE

Sara Weller

Forward looking statements

This Annual Report contains certain forward looking statements with respect to the business, strategy and plans of the HBOS Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the HBOS Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the HBOS Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the HBOS Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of the HBOS Group or its management including in respect of statements about the future business and economic environments in the UK and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the HBOS Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates (including low or negative rates), exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the HBOS Group's or Lloyds Banking Group plc's or Lloyds Bank plc's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, the exit by the UK from the European Union (EU) and the potential for one or more other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to cyber security; natural, pandemic and other disasters, adverse weather and similar contingencies outside the HBOS Group's or Lloyds Banking Group plc's or Lloyds Bank plc's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the HBOS Group's or Lloyds Banking Group plc's or Lloyds Bank plc's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the US or elsewhere including the implementation and interpretation of key legislation and regulation; the ability to attract and retain senior management and other employees; requirements or limitations on Lloyds Banking Group plc, Lloyds Bank plc and the HBOS Group as a result of HM Treasury's investment in Lloyds Banking Group plc; actions or omissions by the HBOS Group's directors, management or employees including industrial action; changes to the HBOS Group's post-retirement defined benefit scheme obligations; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the HBOS Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this Annual Report are made as of the date hereof, and the HBOS Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this Annual Report to reflect any change in the HBOS Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

The information, statements and opinions contained in this Annual Report do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

HBOS plc
Independent auditors' report

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF HBOS PLC

Report on the financial statements

Our opinion

In our opinion:

- HBOS plc's Group financial statements and Company financial statements (the "financial statements") give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2016 and of the Group's profit and the Group's and the Company's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union;
- the Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

What we have audited

The financial statements, included within the Report and Accounts (the "Annual Report"), comprise:

- the Consolidated balance sheet and Company balance sheet as at 31 December 2016;
- the Consolidated income statement and Statements of comprehensive income for the year then ended;
- the Consolidated cash flow statement and Company cash flow statement for the year then ended;
- the Consolidated statement of changes in equity and Company statement of changes in equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is IFRSs as adopted by the European Union and, as regards the Company financial statements, as applied in accordance with the provisions of the Companies Act 2006, and applicable law.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic report and the Directors' report have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the Group, the Company and their environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Directors' report. We have nothing to report in this respect.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of directors' responsibilities set out on page 7, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

What an audit of financial statements involves

We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

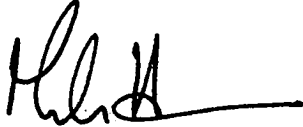
- whether the accounting policies are appropriate to the Group's and the Company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

HBOS plc
Independent auditors' report

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Directors' report, we consider whether those reports include the disclosures required by applicable legal requirements.



Mark Hannam (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London

20 March 2017

- (a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
- (b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

HBOS plc
Consolidated income statement
for the year ended 31 December 2016

	Note	2016 £ million	2015 £ million
Interest and similar income		9,759	10,459
Interest and similar expense		(3,398)	(3,753)
Net interest income	5	6,361	6,706
Fee and commission income		787	806
Fee and commission expense		(360)	(323)
<i>Net fee and commission income</i>	6	<i>427</i>	<i>483</i>
Net trading income	7	280	152
Other operating income	8	608	44
Other income		1,315	679
Total income		7,676	7,385
Regulatory provisions		(635)	(1,421)
Other operating expenses		(3,031)	(3,031)
Total operating expenses	9	(3,666)	(4,452)
Trading surplus		4,010	2,933
Impairment	10	(206)	(193)
Profit before tax		3,804	2,740
Taxation	11	(1,198)	(729)
Profit for the year		2,606	2,011
Profit attributable to ordinary shareholders		2,505	2,011
Profit attributable to non-controlling interests		101	-
Profit for the year		2,606	2,011

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

HBOS plc
Statements of comprehensive income
for the year ended 31 December 2016

The Group	2016 £ million	2015 £ million
Profit for the year	2,606	2,011
Other comprehensive income		
<i>Items that will not subsequently be reclassified to profit or loss:</i>		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before taxation	(697)	(143)
Taxation	132	27
	(565)	(116)
<i>Items that may subsequently be reclassified to profit or loss:</i>		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	94	(16)
Income statement transfers in respect of disposals	(71)	(37)
Income statement transfers in respect of impairment	1	38
Taxation	(30)	2
	(6)	(13)
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	122	181
Net income statement transfers	(232)	(554)
Taxation	30	58
	(80)	(315)
Currency translation differences (tax: nil)	-	70
Other comprehensive income for the year, net of tax	(651)	(374)
Total comprehensive income for the year	1,955	1,637
 Total comprehensive income attributable to ordinary shareholders	 1,854	 1,637
Total comprehensive income attributable to non-controlling interests	101	-
Total comprehensive income for the year	1,955	1,637

The Company	2016 £ million	2015 £ million
Profit for the year	3,899	9,398
Other comprehensive income		
<i>Items that will not subsequently be reclassified to profit or loss:</i>		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before taxation	(673)	(169)
Taxation	128	27
	(545)	(142)
<i>Items that may subsequently be reclassified to profit or loss:</i>		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	4	-
Taxation	-	-
	4	-
Currency translation differences (tax: nil)	-	(15)
Other comprehensive income for the year, net of tax	(541)	(157)
Total comprehensive income for the year	3,358	9,241

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

HBOS plc
Consolidated balance sheet
at 31 December 2016

	Note	2016 £ million	2015 £ million
Assets			
Cash and balances at central banks		2,840	2,481
Items in the course of collection from banks		188	172
Trading and other financial assets at fair value through profit or loss	12	2,397	5,828
Derivative financial instruments	13	14,664	14,926
Loans and receivables:			
Loans and advances to banks	14	1,116	691
Loans and advances to customers	15	268,899	270,837
Debt securities		169	182
Due from fellow Lloyds Banking Group undertakings		46,911	31,560
		317,095	303,270
Available-for-sale financial assets	19	3,034	4,557
Goodwill	21	325	325
Other intangible assets	22	100	102
Property, plant and equipment	23	1,106	1,192
Current tax recoverable		7	-
Deferred tax assets	31	1,998	1,941
Retirement benefit assets	30	86	675
Other assets	24	438	533
Total assets		344,278	336,002

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

HBOS plc
Consolidated balance sheet
at 31 December 2016

	Note	2016 £ million	2015 £ million
Equity and liabilities			
Liabilities			
Deposits from banks	25	6,191	1,541
Customer deposits	26	179,317	190,046
Due to fellow Lloyds Banking Group undertakings		99,581	80,047
Items in course of transmission to banks		248	342
Trading and other financial liabilities at fair value through profit or loss	27	945	4,415
Derivative financial instruments	13	13,225	12,744
Notes in circulation		1,402	1,112
Debt securities in issue	28	16,679	18,492
Other liabilities	29	785	1,046
Retirement benefit obligations	30	250	188
Current tax liabilities		825	345
Other provisions	32	1,846	1,899
Subordinated liabilities	33	8,149	8,304
Total liabilities		329,443	320,521
Equity			
Share capital	34	3,763	3,763
Share premium account	35	-	-
Other reserves	36	10,393	10,479
Retained profits	37	(858)	(298)
Shareholders' equity		13,298	13,944
Non-controlling interests ¹		1,537	1,537
Total equity		14,835	15,481
Total equity and liabilities		344,278	336,002

¹See note 1.

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

The directors approved the consolidated financial statements on 20 March 2017.

Lord Blackwell
Chairman



António Horta-Osório
Chief Executive



George Culmer
Chief Financial Officer



HBOS plc
Consolidated statement of changes in equity
for the year ended 31 December 2016

	Attributable to equity shareholders				Non-controlling interests ¹ £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million		
Balance at 1 January 2015	22,418	10,737	(9,437)	23,718	37	23,755
Comprehensive income						
Profit for the year	-	-	2,011	2,011	-	2,011
<i>Other comprehensive income</i>						
Post-retirement defined benefit scheme remeasurements, net of tax	-	-	(116)	(116)	-	(116)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	-	(13)	-	(13)	-	(13)
Movements in cash flow hedging reserve, net of tax	-	(315)	-	(315)	-	(315)
Currency translation differences, net of tax	-	70	-	70	-	70
Total other comprehensive income	-	(258)	(116)	(374)	-	(374)
Total comprehensive income	-	(258)	1,895	1,637	-	1,637
Transactions with owners						
Dividends (note 38)	-	-	(11,500)	(11,500)	-	(11,500)
Capital contribution received	-	-	89	89	-	89
Repayment of capital contribution	-	-	-	-	-	-
Capital restructuring	(18,655)	-	18,655	-	-	-
Change in non-controlling interests	-	-	-	-	1,500	1,500
Total transactions with owners	(18,655)	-	7,244	(11,411)	1,500	(9,911)
Balance at 31 December 2015	3,763	10,479	(298)	13,944	1,537	15,481
Comprehensive income						
Profit for the year	-	-	2,505	2,505	101	2,606
<i>Other comprehensive income</i>						
Post-retirement defined benefit scheme remeasurements, net of tax	-	-	(565)	(565)	-	(565)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	-	(6)	-	(6)	-	(6)
Movements in cash flow hedging reserve, net of tax	-	(80)	-	(80)	-	(80)
Currency translation differences, net of tax	-	-	-	-	-	-
Total other comprehensive income	-	(86)	(565)	(651)	-	(651)
Total comprehensive income	-	(86)	1,940	1,854	101	1,955
Transactions with owners						
Dividends (note 38)	-	-	(2,610)	(2,610)	-	(2,610)
Distributions to non-controlling interests, net of tax	-	-	28	28	(101)	(73)
Capital contribution received	-	-	82	82	-	82
Total transactions with owners	-	-	(2,500)	(2,500)	(101)	(2,601)
Balance at 31 December 2016	3,763	10,393	(858)	13,298	1,537	14,835

¹ See note 1.

Further details of movements in the Group's share capital and reserves are provided in notes 34, 35, 36, 37 and 38.

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

HBOS plc
Consolidated cash flow statement
for the year ended 31 December 2016

	Note	2016 £ million	2015 £ million
Profit before tax		3,804	2,740
Adjustments for:			
Change in operating assets	47(a)	(7,730)	40,282
Change in operating liabilities	47(b)	11,750	(32,171)
Non-cash and other items	47(c)	(3,096)	(1,678)
Tax paid		(633)	(460)
Net cash provided by operating activities		4,095	8,713
Cash flows from investing activities			
Purchase of available-for-sale financial assets		(297)	(11,368)
Proceeds from sale and maturity of available-for-sale financial assets		2,291	12,017
Purchase of fixed assets		(131)	(136)
Proceeds from sale of fixed assets		112	92
Acquisition of businesses, net of cash acquired		-	(5)
Disposal of businesses, net of cash disposed	47(e)	5	22
Net cash provided by investing activities		1,980	622
Cash flows from financing activities			
Dividends paid to ordinary shareholders	38	(2,610)	(11,500)
Distributions on other equity instruments		(101)	-
Movements in non-controlling interests ¹		-	1,500
Interest paid on subordinated liabilities		(411)	(474)
Repayment of subordinated liabilities	33	(1,113)	(1,310)
Capital repayment to ultimate parent company		(1,198)	-
Net cash used in financing activities		(5,433)	(11,784)
Effects of exchange rate changes on cash and cash equivalents		18	2
Change in cash and cash equivalents		660	(2,447)
Cash and cash equivalents at beginning of year		2,392	4,839
Cash and cash equivalents at end of year	47(d)	3,052	2,392

¹ See note 1.

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

HBOS plc
Company balance sheet
at 31 December 2016

	Note	2016 £ million	2015 £ million
Assets			
Amounts owed by Group entities		14,434	16,082
Derivative financial instruments	13	499	586
Available for sale financial assets		4	–
Retirement benefit assets	30	86	675
Investments in subsidiary undertakings	20	22,289	22,206
Total assets		37,312	39,549
Liabilities			
Amounts owed to Group entities		7,155	10,286
Other liabilities	29	509	529
Current tax liabilities		22	36
Retirement benefit obligations	30	220	169
Deferred tax liabilities	31	11	138
Subordinated liabilities	33	6,132	5,958
Total liabilities		14,049	17,116
Equity			
Issued share capital	34	3,763	3,763
Share premium account	35	–	–
Other reserves	36	9,682	9,678
Retained profits ¹	37	9,818	8,992
Shareholders' equity		23,263	22,433
Total equity and liabilities		37,312	39,549

¹ The company recorded a profit after tax for the year of £3,899 million (2015: £9,398 million).

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

Approved by the Board on 20 March 2017 and signed on its behalf by:

Lord Blackwell
Chairman

António Horta-Osório
Chief Executive

George Culmer
Chief Financial Officer





Company statement of changes in equity
for the year ended 31 December 2016

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 1 January 2015	22,418	9,693	(7,520)	24,591
Comprehensive income				
Profit for the year	–	–	9,398	9,398
<i>Other comprehensive income</i>				
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(142)	(142)
Currency translation differences, net of tax	–	(15)	–	(15)
Total comprehensive income	–	(15)	9,256	9,241
Transactions with owners				
Capital contribution received	–	–	101	101
Capital restructuring	(18,655)	–	18,655	–
Dividends (note 38)	–	–	(11,500)	(11,500)
Total transactions with owners	(18,655)	–	7,256	(11,399)
Balance at 31 December 2015	3,763	9,678	8,992	22,433
Comprehensive income				
Profit for the year	–	–	3,899	3,899
<i>Other comprehensive income</i>				
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(545)	(545)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	4	–	4
Total comprehensive income	–	4	3,354	3,358
Transactions with owners				
Capital contribution received	–	–	82	82
Dividends (note 38)	–	–	(2,610)	(2,610)
Total transactions with owners	–	–	(2,528)	(2,528)
Balance at 31 December 2016	3,763	9,682	9,818	23,263

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

HBOS plc
Company cash flow statement
for the year ended 31 December 2016

	Note	2016 £ million	2015 £ million
Profit before tax		3,949	9,406
Adjustments for:			
Change in operating assets		(22)	765
Change in operating liabilities		(3,151)	594
Non-cash and other items		(2,235)	569
Tax paid		(61)	–
Net cash used in operating activities		(1,520)	11,334
Cash flows from financing activities			
Dividends paid to ordinary shareholders	38	(2,610)	(11,500)
Dividends received		3,500	–
Repayment of subordinated liabilities	33	(750)	(1,063)
Interest paid on subordinated liabilities		(290)	(329)
Net cash used in financing activities		(150)	(12,892)
Change in cash and cash equivalents		(1,670)	(1,558)
Cash and cash equivalents at beginning of year		8,662	10,220
Cash and cash equivalents at end of year		6,992	8,662

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

HBOS plc
Notes to the accounts

1 Basis of preparation

The financial statements of HBOS plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB. The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies which are set out in the Principal risks and uncertainties section under Funding and Liquidity risk on page 5 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2016 and which have not been applied in preparing these financial statements are given in note 49.

During 2016 the Group has reviewed the reporting of the AT1 equity instruments issued by its subsidiary, Bank of Scotland plc, and these have been reclassified to non-controlling interests; comparatives have been restated accordingly, increasing non-controlling interests by £1,500 million and reducing other equity instruments by the same amount. There is no impact on total equity.

2 Accounting policies

The accounting policies are set out below. These accounting policies have been applied consistently.

a Consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, joint ventures and associates. Details of the Group's subsidiaries and related undertakings are given on pages 95 to 97.

(1) Subsidiaries

Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the Group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(4)) or share capital (see 2o). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates

Joint ventures are joint arrangements over which the Group has joint control under a contractual arrangement with other parties and has rights to the net assets of the arrangements. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity but is not control or joint control of those policies and is generally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting.

HBOS plc
Notes to the accounts

2 Accounting policies (continued)

b Goodwill

Goodwill arises on business combinations and represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

c Other intangible assets

Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows: up to 7 years for capitalised software; 10 to 15 years for brands and other intangibles.

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

d Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability, including early redemption fees, and related penalties; and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account.

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility.

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

Revenue recognition policies specific to leases are set out in (j)(2) below.

e Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. The Group initially recognises loans and receivables, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

(1) Financial instruments at fair value through profit or loss

Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see (f) below).

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

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

- it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.
- the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis.
- where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. Refer to 42(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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2 Accounting policies (continued)

(2) Available-for-sale financial assets

Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss, held-to-maturity investments or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Such assets are intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would otherwise have met the definition of loans and receivables at the time of reclassification and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity. Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

(3) Loans and receivables

Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see d above) less provision for impairment (see h below).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) Borrowings

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

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, net of tax, as distributions from equity in the period in which they are paid. An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss.

(5) Sale and repurchase agreements

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and receivable or customer deposit.

f Derivative financial instruments and hedge accounting

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. All derivatives are recognised at their fair value. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 42(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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

Derivatives embedded in financial instruments are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item, the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

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2 Accounting policies (continued)

(1) Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) Cash flow hedges

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

(3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instruments used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

g Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. Cash collateral on exchange traded derivative transactions is presented gross unless the collateral cash flows are always settled net with the derivative cash flows. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

h Impairment of financial assets

(1) Assets accounted for at amortised cost

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

Where such an event, including the identification of fraud, has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that forbearance is no longer appropriate. For commercial lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

(2) Available-for-sale financial assets

The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer, assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

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2 Accounting policies (continued)

i Property, plant and equipment

Property, plant and equipment (other than investment property) is included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows: the shorter of 50 years and the remaining period of the lease for freehold/long and short leasehold premises; the shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease for leasehold improvements; 10 to 20 years for fixtures and furnishings; and 2 to 8 years for other equipment and motor vehicles.

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

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

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital accretion or both. In accordance with the guidance published by the Royal Institution of Chartered Surveyors, investment property is carried at fair value based on current prices for similar properties, adjusted for the specific characteristics of the property (such as location or condition). If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets. These valuations are reviewed at least annually by independent professionally qualified valuers. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be valued at fair value.

j Leases

(1) As lessee

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

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

(2) As lessor

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

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

k Employee benefits

Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services.

(1) Pension schemes

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

Scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. The Group's income statement charge includes the current service cost of providing pension benefits, past service costs, net interest expense (income), and plan administration costs that are not deducted from the return on plan assets. Past service costs, which represents the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment, are recognised when the plan amendment or curtailment occurs. Net interest expense (income) is calculated by applying the discount rate at the beginning of the period to the net defined benefit liability or asset.

Remeasurements, comprising actuarial gains and losses, the return on plan assets (excluding amounts included in net interest expense (income) and net of the cost of managing the plan assets), and the effect of changes to the asset ceiling (if applicable) are reflected immediately in the balance sheet with a charge or credit recognised in other comprehensive income in the period in which they occur. Remeasurements recognised in other comprehensive income are reflected immediately in retained profits and will not subsequently be reclassified to profit or loss.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes. In assessing whether a surplus is recoverable, the Group considers its current right to obtain a refund or a reduction in future contributions and does not anticipate any future acts by other parties that could change the amount of the surplus that may ultimately be recovered.

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

(2) Share-based compensation

Lloyds Banking Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the

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2 Accounting policies (continued)

instruments with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

l Taxation

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

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities including open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law. Dependent on their complexity, provisions are based on management's interpretation of the relevant tax legislation, precedents and guidance as well as external tax advice. The provision is the best estimate of the consideration expected to be required to settle the particular obligation taking into account management's judgement of the relevant risks and uncertainties.

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

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

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

m Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows: the assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see f(3) above). On disposal or liquidation of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal or liquidation.

n Provisions and contingent liabilities

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

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

Provision is made for irrevocable undrawn loan commitments if it is probable that the facility will be drawn and result in the recognition of an asset at an amount less than the amount advanced.

o Share capital

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds. Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

p Cash and cash equivalents

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

q Investment in subsidiaries

Investments in subsidiaries are carried at historical cost, less any provisions for impairment.

Notes to the accounts

3 Critical accounting estimates

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows:

- Allowance for impairment losses on loans and receivables (note 18);
- Defined benefit pension scheme obligations (note 30);
- Recoverability of deferred tax assets (note 31);
- Payment protection insurance and other regulatory provisions (note 32); and
- Fair value of financial instruments (note 42).

4 Segmental analysis

IFRS 8 'Operating Segments' requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee of Lloyds Banking Group. The HBOS Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the HBOS Group's performance and allocate resources across any segments, accordingly no segmental information is provided. A brief overview of the Group's sources of income is provided in the strategic review. The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

Following the reduction in the Group's non-UK activities, an analysis between UK and non-UK activities is no longer provided.

5 Net interest income

	Weighted average effective interest rate		2016 £m	2015 £m
	2016 %	2015 %		
Interest and similar income:				
Interest receivable on loans and receivables	3.14	3.19	9,722	10,379
Available-for-sale financial assets	0.96	1.66	37	80
Total interest and similar income	3.11	3.17	9,759	10,459
Interest and similar expense:				
Deposits from banks and customer deposits	1.13	1.20	(2,872)	(3,157)
Debt securities in issue	0.62	0.84	(110)	(166)
Subordinated liabilities	5.22	4.98	(416)	(430)
Total interest and similar expense	1.22	1.29	(3,398)	(3,753)
Net interest income			6,361	6,706

Included within interest and similar income is £117 million (2015: £125 million) in respect of impaired financial assets. Net interest income also includes a credit of £232 million (2015: credit of £554 million) transferred from the cash flow hedging reserve (see note 36).

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6 Net fee and commission income

	2016 £m	2015 £m
Fee and commission income:		
Current accounts	231	242
Credit and debit card fees	229	233
Other	327	331
Total fee and commission income	787	806
Fee and commission expense	(360)	(323)
Net fee and commission income	427	483

Fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

7 Net trading income

	2016 £m	2015 £m
Foreign exchange translation gains	224	61
Gains on foreign exchange trading transactions	32	50
Total foreign exchange	256	111
Investment property gains (note 23)	2	7
Securities and other gains (see below)	22	34
Net trading income	280	152

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

	2016 £m	2015 £m
Net income arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances	58	54
Equity shares	3	159
Total net income arising on assets held at fair value through profit or loss	61	213
Net expense arising on liabilities held at fair value through profit or loss	(1)	-
Total net (losses) gains arising on assets and liabilities held at fair value through profit or loss	60	213
Net gains (losses) on financial instruments held for trading	(38)	(179)
Securities and other gains	22	34

8 Other operating income

	2016 £m	2015 £m
Operating lease rental income	24	24
Rental income from investment properties (note 23)	3	5
Gains on disposal of available-for-sale financial assets (note 36)	71	37
Share of results of joint ventures and associates	(1)	(3)
Liability management ¹	435	-
Other	76	(19)
Total other operating income	608	44

¹ During 2016 a gain of £435 million arose on a restructuring of capital instruments within the Lloyds Banking Group.

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Notes to the accounts

9 Operating expenses

	2016 £m	2015 £m
Staff costs:		
Salaries	1,148	1,178
Social security costs	121	121
Pensions and other post-retirement benefit schemes (note 30):	225	214
Restructuring costs	8	–
Other staff costs	10	20
	1,512	1,533
Premises and equipment:		
Rent and rates	159	155
Repairs and maintenance	15	14
Other	22	91
	196	260
Other expenses:		
Communications and data processing	151	164
Advertising and promotion	50	67
Professional fees	5	14
Other	945	819
	1,151	1,064
Depreciation and amortisation:		
Depreciation of property, plant and equipment (note 23)	143	150
Amortisation of other intangible assets (note 22)	29	24
	172	174
Total operating expenses, excluding regulatory provisions	3,031	3,031
Regulatory provisions:		
Payment protection insurance, provision (note 32)	266	1,102
Other regulatory provisions (note 32)	369	319
	635	1,421
Total operating expenses	3,666	4,452

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9 Operating expenses (continued)

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

	2016	2015
UK	35,350	35,982
Overseas	402	369
Total	35,752	36,351

Fees payable to the Company's auditors

During the year the auditors earned the following fees:

	2016 £m	2015 £m
Fees payable for the audit of the Company's current year annual report	1.0	1.1
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	2.8	2.3
Other services supplied pursuant to legislation	0.6	0.5
Total fees payable to the Company's auditors by the Group	4.4	3.9

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

	2016 £m	2015 £m
Reviews of the financial position of corporate and other borrowers	–	0.1

10 Impairment

	2016 £m	2015 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	216	217
Debt securities classified as loans and receivables	–	(2)
Total impairment losses on loans and receivables (note 18)	216	215
Impairment of available-for-sale financial assets	–	4
Other credit risk provisions	(10)	(26)
Total impairment charged to the income statement	206	193

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

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11 Taxation

a Analysis of tax charge for the year

	2016 £m	2015 £m
UK corporation tax:		
Current tax on profit for the year	(749)	(284)
Adjustments in respect of prior years	(369)	(48)
	(1,118)	(332)
Foreign tax:		
Current tax on profit for the year	(12)	(16)
Adjustments in respect of prior years	13	(2)
	1	(18)
Current tax charge	(1,117)	(350)
Deferred tax (note 31):		
Origination and reversal of temporary differences	(328)	(412)
Due to change in UK corporation tax rate	(75)	30
Adjustments in respect of prior years	322	3
	(81)	(379)
Tax charge	(1,198)	(729)

The tax charge for 2016 is based on a UK corporation tax rate of 20 per cent (2015: 20.25 per cent).

b Factors affecting the tax charge for the year

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

	2016 £m	2015 £m
Profit before tax	3,804	2,740
Tax charge thereon at UK corporation tax rate of 20 per cent (2015: 20.25 per cent).	(761)	(555)
Factors affecting charge:		
Impact of bank surcharge	(303)	–
Impact of changes in UK corporation tax rates	(75)	30
Disallowed items ¹	(123)	(203)
Non-taxable items	69	21
Overseas tax rate differences	(1)	(5)
Gains exempted	18	31
Tax losses not previously recognised	11	–
Adjustments in respect of previous years	(34)	(47)
Effect of results of joint ventures and associates	–	(1)
Other items	1	–
Tax charge on profit on ordinary activities	(1,198)	(729)

¹The Finance (No. 2) Act 2015 introduced restrictions on the tax deductibility of provisions for conduct charges arising on or after 8 July 2015. This has resulted in an additional income statement tax charge of £87 million (2015: £151 million).

The Finance (No. 2) Act 2015 introduced an additional surcharge of 8 per cent on banking profits from 1 January 2016.

The Finance Act 2016 was enacted on 15 September 2016. The Act further reduced the corporation tax rate applicable from 1 April 2020 to 17 per cent and further restricts the amount of banks' profits that can be offset by carried forward losses for the purposes of calculating corporation tax liabilities from 50 per cent to 25 per cent with effect from 1 April 2016.

The corporation tax changes enacted have resulted in a reduction in the Group's net deferred tax asset at 31 December 2016 of £81 million, comprising a £75 million charge included in the income statement and a £6 million charge included in equity.

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12 Trading and other financial assets at fair value through profit or loss of the Group

	2016 £m	2015 £m
Trading assets	943	4,230
Other financial assets at fair value through profit or loss	1,454	1,598
Total	2,397	5,828

These assets are comprised as follows:

	2016		2015	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to customers	943	–	4,230	–
Debt securities: Corporate and other debt securities	–	1,335	–	1,372
Equity shares	–	119	–	226
Total	943	1,454	4,230	1,598

At 31 December 2016 £119 million (2015: £221 million) of trading and other financial assets at fair value through profit or loss had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase and reverse repurchase agreements see note 45.

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13 Derivative financial instruments

The fair values and notional amounts of derivative instruments are set out in the following table:

The Group	2016			2015		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	1,201	145	20	2,141	35	23
Currency swaps	46,121	1,181	1,063	48,813	1,172	861
Options purchased	165	11	–	215	12	–
Options written	208	–	9	251	–	12
	47,695	1,337	1,092	51,420	1,219	896
Interest rate contracts:						
Interest rate swaps	199,031	7,880	8,726	236,948	8,415	8,567
Forward rate agreements	5,159	–	1	39,112	11	14
Options purchased	3,213	747	–	6,180	691	–
Options written	3,839	–	868	7,590	–	782
Futures	5,959	–	–	22,451	–	–
	217,201	8,627	9,595	312,281	9,117	9,363
Credit derivatives	712	–	10	541	–	11
Equity and other contracts	276	387	360	471	382	372
Total derivative assets/liabilities held for trading	265,884	10,351	11,057	364,713	10,718	10,642
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	16,968	2,690	194	21,646	2,804	230
Cross currency swaps	11	–	–	469	19	11
	16,979	2,690	194	22,115	2,823	241
Derivatives designated as cash flow hedges:						
Interest rate swaps	39,525	1,623	1,974	44,922	1,385	1,861
Futures	2,817	–	–	7,487	–	–
	42,342	1,623	1,974	52,409	1,385	1,861
Total derivative assets/liabilities held for hedging	59,321	4,313	2,168	74,524	4,208	2,102
Total recognised derivative assets/liabilities	325,205	14,664	13,225	439,237	14,926	12,744

The notional amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 45 Credit risk.

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers; and
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 45.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

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13 Derivative financial instruments (continued)

- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

Hedged cash flows

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
2016									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	32	40	84	89	93	404	163	12	917
Forecast payable cash flows	(4)	(5)	(21)	(19)	(22)	(136)	(126)	(3)	(336)

Hedged forecast cash flows affect profit or loss:

Forecast receivable cash flows	45	44	87	92	96	385	157	11	917
Forecast payable cash flows	(8)	(6)	(23)	(21)	(22)	(138)	(115)	(3)	(336)

	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
2015									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	60	54	106	121	144	672	174	18	1,349
Forecast payable cash flows	–	(10)	(36)	(44)	(45)	(197)	(210)	(6)	(548)

Hedged forecast cash flows affect profit or loss:

Forecast receivable cash flows	73	64	109	126	147	643	170	17	1,349
Forecast payable cash flows	–	(25)	(40)	(45)	(46)	(195)	(193)	(4)	(548)

There were no transactions for which cash flow hedge accounting had to be ceased in 2015 or 2016 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2016 £13,792 million of total recognised derivative assets of the Group and £12,665 million of total recognised derivative liabilities of the Group (2015: £13,989 million of assets and £12,093 million of liabilities) had a contractual residual maturity of greater than one year.

	2016			2015		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
The Company						
Trading						
Currency swaps	–	–	–	506	24	–
Interest rate swaps	12	4	–	50	5	–
Total derivative assets/liabilities held for trading	12	4	–	556	29	–
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	2,803	495	–	2,686	557	–
Total recognised derivative assets/liabilities, held for hedging	2,803	495	–	2,686	557	–
Total recognised derivative asset/liabilities	2,815	499	–	3,242	586	–

At 31 December 2016 £499 million of total recognised derivative assets of the Company and £nil of total recognised derivative liabilities of the Company (2015: £584 million of assets and £nil of liabilities) had a contractual residual maturity of greater than one year.

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14 Loans and advances to banks of the Group

	2016 £m	2015 £m
Lending to banks	562	261
Money market placements with banks	554	430
Total loans and advances to banks	1,116	691

No allowance for impaired loans was carried against these exposures at 31 December 2015 or 31 December 2016.

At 31 December 2016 £445 million (2015: £305 million) of loans and advances to banks had a contractual residual maturity of greater than one year.

For amounts included above which are subject to reverse repurchase agreements see note 42.

15 Loans and advances to customers of the Group

	2016 £m	2015 £m
Agriculture, forestry and fishing	616	596
Energy and water supply	207	237
Manufacturing	344	624
Construction	1,380	1,570
Transport, distribution and hotels	2,942	3,227
Postal and telecommunications	242	217
Property companies	6,534	7,107
Financial, business and other services	2,601	3,392
Personal:		
Mortgages	245,327	245,900
Other	10,667	10,191
Lease financing	342	546
Hire purchase	82	40
Total loans and advances to customers before allowance for impairment losses	271,284	273,647
Allowance for impairment losses (note 18)	(2,385)	(2,810)
Total loans and advances to customers	268,899	270,837

At 31 December 2016 £253,796 million (2015: £255,034 million) of loans and advances to customers had a contractual residual maturity of greater than one year.

For amounts included above which are subject to reverse repurchase agreements see note 42.

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

	2016 £m	2015 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	93	115
Later than 1 year and not later than 5 years	169	270
Later than 5 years	200	363
	462	748
Unearned future finance income on finance leases	(110)	(192)
Rentals received in advance	(10)	(10)
Net investment in finance leases	342	546

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15 Loans and advances to customers of the Group (continued)

The net investment in finance leases represents amounts recoverable as follows:

	2016 £m	2015 £m
Not later than 1 year	66	70
Later than 1 year and not later than 5 years	123	206
Later than 5 years	153	270
Net investment in finance leases	342	546

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2015 and 2016 no contingent rentals in respect of finance leases were recognised in the income statement. There was no allowance for uncollectable finance lease receivables included in the allowance for impairment losses for the Group (2015: £nil).

16 Securitisations and covered bonds

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

Covered bond programmes

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value on the notes in issue at 31 December, are listed below. The notes in issue are reported in note 28.

	2016		2015	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	24,164	15,989	26,173	17,963
Credit card receivables	7,610	5,723	7,312	5,277
Dutch residential mortgages	2,033	2,081	1,981	2,044
Commercial loans	411	411	341	341
	34,218	24,204	35,807	25,625
Less held by the Group		(18,642)		(19,208)
Total securitisation programmes (note 28)		5,562		6,417
Covered bond programmes				
Residential mortgage-backed	8,945	9,189	18,615	12,665
Social housing loan-backed	2,087	1,200	2,544	1,700
	11,032	10,389	21,159	14,365
Less held by the Group		(700)		(4,197)
Total covered bond programmes (note 28)		9,689		10,168
Total securitisation and covered bond programmes		15,251		16,585

Cash deposits of £5,713 million (2015: £5,801 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2016 these obligations had not been triggered and the maximum exposure under these facilities was £292 million (2015: £300 million).

The Group has a number of covered bond programmes, for which Limited Liability Partnerships have been established to ring-fence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had over-collateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

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16 Securitisations and covered bonds (continued)

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cashflows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not voluntarily offered to repurchase assets from any of its public securitisation programmes during 2016 (2015: none). Such repurchases are made in order to ensure that the expected maturity dates of the notes issued from these programmes are met.

17 Structured entities

The Group's interests in structured entities are consolidated. Detail of the Group's interests in consolidated structured entities are set out in note 16 for securitisations and covered bonds.

18 Allowance for impairment losses on loans and receivables of the Group

Critical accounting estimates and judgments

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. In determining the required level of impairment provisions, the Group uses the output from various statistical models. Management judgement is required to assess the robustness of the outputs from these models and, where necessary, make appropriate adjustments. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's commercial lending portfolios. Assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watchlist where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that could lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower; (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate; (iii) disappearance of an active market because of financial difficulties; or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. For these portfolios, homogenous loans, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

The value of collateral supporting the Group's UK mortgage portfolio is estimated by applying changes in the house price indices to the original assessed value of the property. Given the relative size of the portfolio, this is a key variable in determining the Group's impairment charge for loans and receivables. If average house prices were ten per cent lower than those estimated at 31 December 2016, the impairment charge would increase by approximately £174 million in respect of UK mortgages.

In addition, the collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been separately identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for commercial lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of assets being impaired at the

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18 Allowance for impairment losses on loans and receivables of the Group (continued)

balance sheet date and being identified subsequently; the length of time taken to identify that an impairment event has occurred is known as the loss emergence period. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Loss emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and twelve months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios. This provision is sensitive to changes in the loss emergence period. Management use a significant level of judgement when determining the collective unidentified impairment provision, including the assessment of the level of overall risk existing within particular sectors and the impact of the low interest rate environment on loss emergence periods. In the Commercial Banking division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unidentified impairment provisions would result in an increase in the collective unidentified impairment provision of approximately £6 million (2015: £8 million).

	2016			2015		
	Loans and advances to customers £m	Debt securities £m	Total £m	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January	2,810	113	2,923	5,683	143	5,826
Exchange and other adjustments	23	–	23	(214)	(3)	(217)
Advances written off	(1,154)	(23)	(1,177)	(3,517)	(29)	(3,546)
Recoveries of advances written off in previous years	479	1	480	622	4	626
Unwinding of discount	11	–	11	19	–	19
Charge to the income statement (note 10)	216	–	216	217	(2)	215
At 31 December	2,385	91	2,476	2,810	113	2,923

Of the Group's total allowance in respect of loans and advances to customers, £1,609 million (2015: £2,061 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £1,749 million (2015: £1,677 million) was assessed on a collective basis.

19 Available-for-sale financial assets of the Group

	2016 £m	2015 £m
Debt securities:		
Government securities	116	96
Bank and building society certificates of deposit	–	17
Mortgage-backed securities	13	82
Corporate and other debt securities	2,424	3,984
	2,553	4,179
Equity shares	481	378
Total available-for-sale financial assets	3,034	4,557

At 31 December 2016 £2,668 million (2015: £4,149 million) of available-for-sale financial assets had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2h(2).

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20 Investment in subsidiary undertakings of the Company

	2016 £m	2015 £m
At 1 January	22,206	22,365
Additional capital injections and transfers	83	100
Impairment	–	(259)
At 31 December	22,289	22,206

Details of the subsidiaries and related undertakings are given on pages 95 to 97 and are incorporated by reference.

Certain subsidiary companies currently have insufficient distributable reserves to make dividend payments, however, there were no further significant restrictions on any of the Company's subsidiaries in paying dividends or repaying loans and advances. All regulated subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

21 Goodwill

	2016 £m	2015 £m
At 1 January and 31 December	325	325
Cost ¹	1,838	1,838
Accumulated impairment losses	(1,513)	(1,513)
At 31 December	325	325

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. This compares the estimated recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; the entire balance of £325 million (2015: £325 million) has been allocated to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2016 has been based upon value in use. This calculation uses cash flow projections based upon the five year business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are not considered for the purposes of impairment testing. The discount rate used in discounting the projected cash flows is 10 per cent (pre-tax) reflecting, inter alia, the perceived risks within those businesses. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount to fall below the balance sheet carrying value.

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22 Other intangible assets

	The Group			The Company	
	Purchased credit card relationships £m	Brands £m	Capitalised software enhancements £m	Total £m	Brands £m
Cost:					
At 1 January 2015	15	24	143	182	10
Additions	–	–	26	26	–
Disposals	–	(14)	–	(14)	(10)
At 31 December 2015	15	10	169	194	–
Additions	–	–	27	27	–
At 31 December 2016	15	10	196	221	–
Accumulated amortisation:					
At 1 January 2015	5	24	53	82	10
Charge for the year (note 9)	3	–	21	24	–
Disposals	–	(14)	–	(14)	(10)
At 31 December 2015	8	10	74	92	–
Charge for the year (note 9)	3	–	26	29	–
At 31 December 2016	11	10	100	121	–
Balance sheet amount at 31 December 2016	4	–	96	100	–
Balance sheet amount at 31 December 2015	7	–	95	102	–

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

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23 Property, plant and equipment

	Investment properties £m	Premises £m	Equipment £m	Operating lease assets £m	Total £m
Cost or valuation:					
At 1 January 2015	178	1,428	1,850	260	3,716
Exchange and other adjustments	–	(3)	2	(2)	(3)
Additions	–	39	70	1	110
Change in fair value of investment properties (note 7)	7	–	–	–	7
Disposals	(74)	(49)	(173)	(3)	(299)
At 31 December 2015	111	1,415	1,749	256	3,531
Exchange and other adjustments	–	2	2	17	21
Additions	–	26	55	4	85
Expenditure on investment properties	19	–	–	–	19
Change in fair value of investment properties (note 7)	2	–	–	–	2
Disposals	(29)	(46)	(23)	–	(98)
At 31 December 2016	103	1,397	1,783	277	3,560
Accumulated depreciation and impairment:					
At 1 January 2015	–	877	1,390	132	2,399
Exchange and other adjustments	–	(2)	(2)	(2)	(6)
Depreciation charge for the year (note 9)	–	58	84	8	150
Disposals	–	(31)	(173)	–	(204)
At 31 December 2015	–	902	1,299	138	2,339
Exchange and other adjustments	–	1	(5)	16	12
Depreciation charge for the year (note 9)	–	59	82	2	143
Disposals	–	(17)	(23)	–	(40)
At 31 December 2016	–	945	1,353	156	2,454
Balance sheet amount at 31 December 2016	103	452	430	121	1,106
Balance sheet amount at 31 December 2015	111	513	450	118	1,192

The table above analyses movements in investment properties, all of which are categorised as level 3. See note 42 for details of levels in the fair value hierarchy.

Rental income of £3 million (2015: £5 million) and direct operating expenses arising from properties that generate rental income of £nil (2015: £nil) have been recognised in the income statement.

There was no capital expenditure in respect of investment properties which had been contracted for but not recognised in the financial statements (2015: £nil).

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

	2016 £m	2015 £m
Receivable within 1 year	8	19
1 to 5 years	9	17
Total future minimum rentals receivable	17	36

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2015 and 2016 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £27 million at 31 December 2016 (2015: £nil) is expected to be received under non-cancellable sub-leases of the Group's premises.

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24 Other assets of the Group

	2016 £m	2015 £m
Settlement balances	117	27
Investments in joint ventures and associates	33	40
Other assets and prepayments	288	466
Total other assets	438	533

25 Deposits from banks of the Group

	2016 £m	2015 £m
Liabilities in respect of securities sold under repurchase agreements	4,521	17
Other deposits from banks	1,670	1,524
Total deposits from banks	6,191	1,541

At 31 December 2016 £6,124 million (2015: £1,307 million) of deposits from banks had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45.

26 Customer deposits of the Group

	2016 £m	2015 £m
Non-interest bearing current accounts	18,139	16,948
Interest bearing current accounts	29,407	24,842
Savings and investment accounts	117,016	132,690
Other customer deposits	14,755	15,566
Total customer deposits	179,317	190,046

At 31 December 2016 £17,061 million (2015: £21,390 million) of customer deposits of the Group had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45.

27 Trading and other financial liabilities at fair value through profit or loss of the Group

	2016 £m	2015 £m
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	943	4,414
Short positions in securities	–	–
Total trading liabilities	943	4,414
Other financial liabilities at fair value through profit or loss	2	1
Total trading and other financial liabilities at fair value through profit or loss	945	4,415

At 31 December 2016 £nil (2015: £nil) of trading and other financial liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45.

For the fair value of collateral pledged in respect of repurchase agreements see note 45.

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28 Debt securities in issue of the Group

	2016 £m	2015 £m
Medium-term notes issued	1,377	1,882
Covered bonds (note 16)	9,689	10,168
Securitisation notes (note 16)	5,562	6,417
	16,628	18,467
Amounts due to fellow Group undertakings	51	25
Total debt securities in issue	16,679	18,492

At 31 December 2016 £11,672 million (2015: £15,813 million) of debt securities in issue had a contractual residual maturity of greater than one year.

29 Other liabilities

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Settlement balances	101	1	–	–
Other creditors and accruals	684	1,045	509	529
	785	1,046	509	529

30 Retirement benefit obligations

	The Group	
	2016 £m	2015 £m
Charge to the Group income statement		
Defined benefit pension schemes	123	117
Other post-retirement benefit schemes	5	4
Total defined benefit schemes	128	121
Defined contribution pension schemes	97	93
Total charge to the income statement	225	214

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Amounts recognised in the balance sheet				
Retirement benefit assets	86	675	86	675
Retirement benefit obligations	(250)	(188)	(220)	(169)
Total amounts recognised in the balance sheet	(164)	487	(134)	506

The total amount recognised in the balance sheet relates to:

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Pension schemes				
Defined benefit pension schemes	(49)	579	(19)	598
Other post-retirement benefit schemes	(115)	(92)	(115)	(92)
Total amounts recognised in the balance sheet	(164)	487	(134)	506

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30 Retirement benefit obligations (continued)

Defined benefit schemes

Critical accounting estimates and judgments

The value of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The discount rate is required to be set with reference to market yields at the end of the reporting period on high quality corporate bonds in the currency and with a term consistent with the defined benefit pension schemes' obligations. The average duration of the schemes' obligations is approximately 22 years. The market for bonds with a similar duration is illiquid and, as a result, significant management judgement is required to determine an appropriate yield curve on which to base the discount rate. The cost of the benefits payable by the schemes will also depend upon the life expectancy of the members. The Group considers latest market practice and actual experience in determining the appropriate assumptions for both current mortality expectations and the rate of future mortality improvement. Given the advances in medical science in recent years, it is uncertain whether this rate of improvement will be sustained going forward and, as a result, actual experience may differ from current expectations. The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in (iii) below.

(i) Characteristics of and risks associated with the Group's schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas. All significant schemes are based in the UK, with the most significant being the defined benefit section of the HBOS Final Salary Pension Scheme. These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2016 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The Group operates a number of funded and unfunded pension arrangements, the majority, including the most significant scheme, are funded schemes in the UK. All these schemes are operated as separate legal entities under trust law by the trustees and are in compliance with the Pensions Act 2004. A valuation exercise is carried out for each scheme at least every three years, whereby scheme assets are measured at market value and liabilities (technical provisions) are measured using prudent assumptions. If a deficit is identified a recovery plan is agreed between the Group and the scheme Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as the future economic benefits arising from these contributions are expected to be available to the Group. The Group's overseas defined benefit pension schemes are subject to local regulatory arrangements.

The latest full valuation of the main scheme was carried out as at 30 June 2014; the results have been updated to 31 December 2016 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2016 by qualified independent actuaries.

The Group has also established a private limited company which holds assets to provide security for the Group's obligations to the HBOS Final Salary Pension Scheme. At 31 December 2016 this company held assets of approximately £2.8 billion; the company does not make any distributions to the pension scheme. The private limited company is consolidated in the Group's balance sheet. The terms of this arrangement require the Group to maintain assets in this vehicle to agreed minimum values in order to secure obligations owed to the Group pension schemes. The Group has satisfied this requirement during 2016.

The Group currently expects to pay contributions of approximately £150 million to its defined benefit schemes in 2017.

The responsibility for the governance of the Group's funded defined benefit pension schemes lies with the Pension Trustees. Each of the Group's funded UK defined benefit pension schemes is managed by a Trustee Board (the Trustee) whose role is to ensure that their Scheme is administered in accordance with the Scheme rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the triennial valuation process. The Board of Trustees must be composed of representatives of the Company and plan participants in accordance with the Scheme's regulations.

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30 Retirement benefit obligations (continued)

(ii) Amounts in the financial statements

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Amount included in the balance sheet				
Present value of funded obligations	(15,548)	(12,275)	(15,241)	(12,046)
Fair value of scheme assets	15,499	12,854	15,222	12,644
Net amount recognised in the balance sheet	(49)	579	(19)	598
	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Net amount recognised in the balance sheet				
At 1 January	579	693	598	751
Net defined benefit pension expense	(123)	(117)	(120)	(115)
Actuarial gains (losses) on defined benefit obligation	(3,191)	239	(3,156)	218
Return on plan assets	2,514	(388)	2,503	(389)
Employer contributions	175	152	157	135
Exchange and other adjustments	(3)	–	(1)	(2)
At 31 December	(49)	579	(19)	598
	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Movements in the defined benefit obligation				
At 1 January	(12,275)	(12,381)	(12,046)	(12,120)
Current service cost	(116)	(127)	(115)	(126)
Interest expense	(465)	(443)	(458)	(438)
Remeasurements:				
Actuarial gains – experience	156	80	153	61
Actuarial (losses) gains – demographic assumptions	70	(273)	73	(273)
Actuarial gains (losses) – financial assumptions	(3,417)	432	(3,382)	430
Benefits paid	544	423	537	418
Past service cost	(16)	(5)	(14)	(5)
Employee contributions	–	(1)	–	(1)
Settlements	12	8	12	9
Exchange and other adjustments	(41)	12	(1)	(1)
At 31 December	(15,548)	(12,275)	(15,241)	(12,046)

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30 Retirement benefit obligations (continued)

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Changes in the fair value of scheme assets				
At 1 January	12,854	13,074	12,644	12,871
Return on plan assets excluding amounts included in interest income	2,514	(388)	2,503	(389)
Interest income	490	473	483	469
Employer contributions	175	152	157	135
Employee contributions	–	1	–	1
Benefits paid	(544)	(423)	(537)	(418)
Settlements	(18)	(13)	(18)	(14)
Administrative costs paid	(10)	(10)	(10)	(10)
Exchange and other adjustments	38	(12)	–	(1)
At 31 December	15,499	12,854	15,222	12,644

Composition of scheme assets:

The Group	2016			2015		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equity instruments	702	–	702	612	–	612
Debt instruments ¹ :						
Fixed interest government bonds	4,881	–	4,881	3,988	–	3,988
Index-linked government bonds	3,256	–	3,256	2,578	–	2,578
Corporate and other debt securities	2,950	–	2,950	2,868	–	2,868
Asset-backed securities	100	–	100	74	–	74
	11,187	–	11,187	9,508	–	9,508
Property	–	484	484	–	419	419
Pooled investment vehicles	644	2,619	3,263	908	2,341	3,249
Money market instruments, derivatives, cash and other assets and liabilities	1,133	(1,270)	(137)	310	(1,244)	(934)
At 31 December	13,666	1,833	15,499	11,338	1,516	12,854

¹ Of the total debt instruments, £10,228 million (31 December 2015: £8,331 million) were investment grade (credit ratings equal to or better than 'BBB').

Company	2016			2015		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equity instruments	649	–	649	576	–	576
Debt instruments ¹ :						
Fixed interest government bonds	4,881	–	4,881	3,988	–	3,988
Index-linked government bonds	3,256	–	3,256	2,578	–	2,578
Corporate and other debt securities	2,937	–	2,937	2,858	–	2,858
	11,074	–	11,074	9,424	–	9,424
Property	–	478	478	–	414	414
Pooled investment vehicles	580	2,619	3,199	859	2,341	3,200
Money market instruments, derivatives, cash and other assets and liabilities	1,092	(1,270)	(178)	274	(1,244)	(970)
At 31 December	13,395	1,827	15,222	11,133	1,511	12,644

¹ Of the total debt instruments, £10,228 million (31 December 2015: £8,331 million) were investment grade (credit ratings equal to or better than 'BBB').

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

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30 Retirement benefit obligations (continued)

The pension schemes' pooled investment vehicles comprise:

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Equity funds	166	118	166	118
Hedge and mutual funds	1,173	980	1,109	931
Liquidity funds	469	742	469	742
Bond and debt funds	65	48	65	48
Other	1,390	1,361	1,390	1,361
At 31 December	3,263	3,249	3,199	3,200

The expense recognised in the income statement for the year ended 31 December comprises:

	The Group	
	2016 £m	2015 £m
Current service cost	116	127
Net interest amount	(25)	(30)
Settlements	6	5
Past service cost – plan amendments	16	5
Plan administration costs incurred during the year	10	10
Total defined benefit pension expense	123	117

Assumptions

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

	2016 %	2015 %
Discount rate	2.76	3.87
Rate of inflation:		
Retail Prices Index	3.23	2.99
Consumer Price Index	2.18	1.99
Rate of salary increases	0.00	0.00
Weighted-average rate of increase for pensions in payment	2.74	2.58
	2016 Years	2015 Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.7	27.7
Women	28.8	28.8
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.9	29.1
Women	30.2	30.3

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 at 31 December 2016 is assumed to live for, on average, 27.7 years for a male and 28.8 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

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30 Retirement benefit obligations (continued)

(iii) Amount, timing and uncertainty of future cash flows

Risk exposure of the defined benefit schemes

Whilst the Group is not exposed to any unusual, entity specific or scheme specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

Inflation rate risk: the majority of the plans' benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings.

Longevity risk: The majority of the schemes obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

Sensitivity analysis

The effect of reasonably possible changes in key assumptions on the value of scheme liabilities and the resulting pension charge in the Group's income statement and on the net defined benefit pension scheme liability, for the Group's most significant scheme, is set out below. The sensitivities provided assume that all other assumptions and the value of the schemes' assets remain unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

	Effect of reasonably possible alternative assumptions			
	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme liability	
	2016 £m	2015 £m	2016 £m	2015 £m
Inflation (including pension increases): ¹				
Increase of 0.1 per cent	7	6	180	127
Decrease of 0.1 per cent	(7)	(6)	(172)	(119)
Discount rate: ²				
Increase of 0.1 per cent	(12)	(12)	(310)	(224)
Decrease of 0.1 per cent	12	12	321	230
Expected life expectancy of members:				
Increase of one year	15	15	423	324
Decrease of one year	(14)	(15)	(410)	(315)

¹At 31 December 2016, the assumed rate of RPI inflation is 3.23 per cent and CPI inflation 2.18 per cent (2015: RPI 2.99 per cent and CPI 1.99 per cent).

²At 31 December 2016, the assumed discount rate is 2.76 per cent (2015: 3.87 per cent).

Sensitivity analysis method and assumptions

The sensitivity analysis above reflects the impact on the Group's most significant scheme which accounts for over 90 per cent of the Group's defined benefit obligations. Whilst differences in the underlying liability profiles for the remainder of the Group's pension arrangements mean they may exhibit slightly different sensitivities to variations in these assumptions, the sensitivities provided above are indicative of the impact across the Group as a whole.

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), and include the impact on the rate of increases to pensions, both before and after retirement. These pension increases are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits.

The sensitivity analysis (including the inflation sensitivity) does not include the impact of any change in the rate of salary increases as pensionable salaries have been frozen since 2 April 2014.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the prior year.

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30 Retirement benefit obligations (continued)

Asset-liability matching strategies

The main scheme's assets are invested in a diversified portfolio, consisting primarily of debt securities. The investment strategy is not static and will evolve to reflect the structure of liabilities within the schemes. Specific asset-liability matching strategies for each pension plan are independently determined by the responsible governance body for each scheme and in consultation with the employer.

A significant goal of the asset-liability matching strategies adopted by Group schemes is to reduce volatility caused by changes in market expectations of interest rates and inflation. In the main scheme, this is achieved by investing scheme assets in bonds, primarily fixed interest gilts and index linked gilts, and by entering into interest rate and inflation swap arrangements. These investments are structured to take into account the profile of scheme liabilities, and actively managed to reflect both changing market conditions and changes to the liability profile.

At 31 December 2016 the asset-liability matching strategy mitigated 79 per cent of the liability sensitivity to interest rate movements and 101 per cent of the liability sensitivity to inflation movements. Much of the residual interest rate sensitivity is mitigated through holdings of corporate and other debt securities.

Maturity profile of defined benefit obligation

The following table provides information on the weighted average duration of the defined benefit pension obligations and the distribution and timing of benefit payments:

	The Group		The Company	
	2016 Years	2015 Years	2016 Years	2015 Years
Duration of the defined benefit obligation	22	21	22	21

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Maturity analysis of benefits expected to be paid				
Benefits expected to be paid within 12 months	563	433	557	433
Benefits expected to be paid between 1 and 2 years	321	302	315	302
Benefits expected to be paid between 2 and 5 years	1,102	1,027	1,080	1,026
Benefits expected to be paid between 5 and 10 years	2,354	2,212	2,309	2,209
Benefits expected to be paid between 10 and 15 years	2,971	2,821	2,918	2,816
Benefits expected to be paid between 15 and 25 years	7,007	6,794	6,879	6,774
Benefits expected to be paid between 25 and 35 years	6,966	6,861	6,844	6,827
Benefits expected to be paid between 35 and 45 years	5,399	5,491	5,320	5,458
Benefits expected to be paid in more than 45 years	3,462	3,929	3,423	3,899

Defined contribution schemes

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow.

During the year ended 31 December 2016 the charge to the income statement in respect of defined contribution schemes was £97 million (2015: £93 million, representing the contributions payable by the employer in accordance with each scheme's rules).

Other post-retirement benefit schemes

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 31 December 2015 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 2.76 per cent (2015: 3.87 per cent).

Movements in the other post-retirement benefit obligation:

	The Group and Company	
	2016 £m	2015 £m
At 1 January	(92)	(91)
Actuarial (loss) gain	(20)	2
Insurance premiums paid	2	1
Charge for the year	(5)	(4)
At 31 December	(115)	(92)

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31 Deferred tax

Critical accounting estimates and judgments

The largest category of deferred tax asset relates to tax losses carried forward. The recoverability of the Group's deferred tax assets in respect of carry forward losses is based on an assessment of future levels of taxable profit expected to arise that can be offset against these losses. The Group's expectations as to the level of future taxable profits take into account the Group's long-term financial and strategic plans, and anticipated future tax adjusting items.

In making this assessment account is taken of business plans, the board approved operating plan and the expected future economic outlook as well as the risks associated with future regulatory change.

The Group's total deferred tax asset includes £1,667 million (2015: £1,661 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc.

The deferred tax asset is expected to be utilised over different time periods in each of the entities in which the losses arise. Under current UK tax law there is no expiry date for unused tax losses. Following the enactment of the Finance Acts in 2015 and 2016, there is a restriction imposed on the amount of banks' profits that can be offset by certain carried forward tax losses for the purposes of calculating corporation tax liabilities. The additional restriction in 2016 has increased the period over which the Group expects to fully utilise its tax losses from 2025 to 2031.

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
The movement in the net deferred tax balance is as follows:				
Asset (liability) at 1 January	1,941	2,226	(138)	(154)
Exchange and other adjustments	2	4	-	-
Disposal of businesses	-	5	-	-
Income statement (charge) credit (note 11):				
Due to change in UK corporation tax rate and related impacts	(75)	30	1	-
Origination and reversal of temporary differences	(6)	(409)	(2)	(11)
	(81)	(379)	(1)	(11)
Amount charged to equity:				
Post-retirement defined benefit scheme remeasurements	132	27	128	27
Available-for-sale financial assets (note 36)	(26)	-	-	-
Cash flow hedges (note 36)	30	58	-	-
	136	85	128	27
Asset (liability) at 31 December	1,998	1,941	(11)	(138)

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Statutory position				
Deferred tax asset	1,998	1,941	-	-
Deferred tax liability	-	-	(11)	(138)
Net deferred tax asset (liability)	1,998	1,941	(11)	(138)
Tax disclosure				
Deferred tax asset	2,032	2,142	-	-
Deferred tax liability	(34)	(201)	(11)	(138)
Net deferred tax asset (liability)	1,998	1,941	(11)	(138)

The deferred tax charge in the consolidated income statement comprises the following temporary differences:

	2016 £m	2015 £m
Accelerated capital allowances	16	115
Pensions and other post-retirement benefits	(1)	(1)
Tax losses carried forward	(9)	(554)
Allowances for impairment losses	-	12
Other temporary differences	(87)	49
Deferred tax charge in the income statement	(81)	(379)

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31 Deferred tax (continued)

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Deferred tax assets:				
Pension and other post-retirement benefits	42	–	–	–
Accelerated capital allowances	277	261	–	–
Tax losses carried forward	1,667	1,661	–	–
Other temporary differences	46	220	–	–
Total deferred tax assets	2,032	2,142	–	–
	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Deferred tax liabilities:				
Pensions and other post-retirement benefits	–	(92)	(11)	(138)
Available-for-sale asset revaluation	(5)	(9)	–	–
Derivatives	(11)	(50)	–	–
Other temporary differences	(18)	(50)	–	–
Total deferred tax liabilities	(34)	(201)	(11)	(138)

The Finance (No. 2) Act 2015 introduced an additional surcharge of 8 per cent on banking profits from 1 January 2016.

The Finance Act 2016 was enacted on 15 September 2016. The Act further reduced the corporation tax rate applicable from 1 April 2020 to 17 per cent and further restricts the amount of banks' profits that can be offset by carried forward losses for the purposes of calculating corporation tax liabilities from 50 per cent to 25 per cent with effect from 1 April 2016.

The corporation tax changes enacted have resulted in a reduction in the Group's net deferred tax asset at 31 December 2016 of £81 million, comprising a £75 million charge included in the income statement and a £6 million charge included in equity.

Deferred tax assets not recognised

Deferred tax assets of £35 million for the Group and £nil for the Company (2015: £93 million for the Group and £nil for the Company) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits to offset them. Capital losses can be carried forward indefinitely.

Deferred tax assets of £84 million for the Group and £nil for the Company (2015: £68 million for the Group and £nil for the Company) have not been recognised in respect of trading losses carried forward, arising in overseas companies, as there are limited predicted future trading profits to offset them. Trading losses can be carried forward indefinitely except for losses in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2016 of £39 million for the Group and £nil for the Company (2015: £39 million for the Group and £nil for the Company), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

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32 Other provisions

Critical accounting estimates and judgments

At 31 December 2016, the Group carried provisions of £1,689 million (2015: £1,658 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches, principally the mis-selling of payment protection insurance (2016: £930 million; 2015: £1,210 million).

Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the scope of reviews required by regulators, the number of future complaints, the extent to which they will be upheld, the average cost of redress and the impact of legal decisions that may be relevant to claims received. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

More detail on the nature of the assumptions that have been made and key sensitivities is set out below.

	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2016	26	1,210	448	215	1,899
Exchange and other adjustments	19	–	–	7	26
Provisions applied	–	(546)	(58)	(94)	(698)
(Release) charge for the year	(10)	266	369	(6)	619
At 31 December 2016	35	930	759	122	1,846

Provisions for commitments

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

Payment protection insurance

The Group increased the provision for PPI costs by a further £266 million in 2016, bringing the total amount provided to £4,787 million.

The charge to the provision in 2016 was largely driven by a higher total volume of complaints expected as a result of the Financial Conduct Authority's (FCA) industry deadline being extended to the end of August 2019 as well as changes to the rules and guidance that should apply when firms handle PPI complaints in light of the UK Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 (Plevin). Final rules and guidance were published by the FCA on 2 March 2017 (PS 17/3).

As at 31 December 2016, a provision of £930 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £546 million during the year to 31 December 2016. Spend continues to reduce following the completion of the re-review of previously handled cases (remediation).

The total amount provided for PPI represents the Group's best estimate of the likely future cost. However a number of risks and uncertainties remain in particular with respect to future volumes. The cost could differ from the Group's estimates and the assumptions underpinning them, and could result in a further provision being required. There is significant uncertainty around the impact of the proposed regulatory changes, FCA media campaign and Claims Management Companies and customer activity.

Key sensitivities are as follows¹:

- the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision by £95 million;
- average uphold rate per policy: an increase of one percentage point in this assumption would increase the provision by £10 million;
- average redress paid per upheld policy: an increase of £100 in this assumption would increase the provision by £55 million.

¹All sensitivities are influenced by a proportion of complaints falling under the Plevin.

Other regulatory provisions

Packaged bank accounts

In the year ended 31 December 2016 the Group has provided an additional £41 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £91 million. As at 31 December 2016, £60 million of the provision remained unutilised. The total amount provided represents the Group's best estimate of the likely future cost, however a number of risks and uncertainties remain in particular with respect to future volumes.

Arrears handling related activities

Following a review of the Group's secured and unsecured arrears handling activities, the Group has put in place a number of actions to further improve its handling of customers in these areas. As a result, the Group has provided an additional £163 million in the year ended 31 December 2016 (bringing the total provision to £278 million), for the costs of identifying and rectifying certain arrears management fees and activities. As at 31 December 2016, the unutilised provision was £278 million (31 December 2015: £115 million).

Other legal actions and regulatory matters

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In the year ended 31 December 2016, the Group charged an additional £165 million in respect of matters across the business. At 31 December 2016, the Group held unutilised provisions totalling £421 million for these other legal actions and regulatory matters.

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32 Other provisions (continued)

Vacant leasehold property and other

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

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

33 Subordinated liabilities

The movement in subordinated liabilities during the year was as follows:

The Group	Preference shares ¹ £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2015	–	2,892	482	6,409	9,783
Repurchases and redemptions during the year:					
4.875% Subordinated Notes 2015	–	–	–	(723)	(723)
8.117% Non-cumulative Perpetual Preferred Securities (Class A)	–	(250)	–	–	(250)
6.05% Fixed to Floating Rate Undated Subordinated Notes	–	–	(18)	–	(18)
5.125% Undated Subordinated Fixed to Floating Rate Notes	–	–	(50)	–	(50)
5.109% Callable Fixed to Floating Rate Notes 2017	–	–	–	(14)	(14)
6.305% Subordinated Callable Fixed to Floating Notes 2017	–	–	–	(35)	(35)
Floating Rate Undated Subordinated Step-up Notes	–	–	(29)	–	(29)
6% Subordinated Notes 2033	–	–	–	(191)	(191)
	–	(250)	(97)	(963)	(1,310)
Exchange and other adjustments	–	(3)	(5)	(161)	(169)
At 31 December 2015	–	2,639	380	5,285	8,304
Repurchases and redemptions during the year:					
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019	–	–	(4)	–	(4)
7.286% Perpetual Regulatory Tier One Securities	–	(150)	–	–	(150)
7.5% Undated Subordinated Step-up Notes	–	–	(5)	–	(5)
Floating Rate Primary Capital Notes	–	–	(108)	–	(108)
4.25% Subordinated Undated Instruments	–	–	(102)	–	(102)
Callable Floating Rate Subordinated Notes 2016 (callable March 2016)	–	–	–	(186)	(186)
Callable Floating Rate Subordinated Notes 2016 (callable September 2016)	–	–	–	(144)	(144)
Subordinated Callable Notes 2016	–	–	–	(382)	(382)
4.939% Non-voting Non-cumulative Perpetual Preferred Securities	–	(32)	–	–	(32)
	–	(182)	(219)	(712)	(1,113)
Exchange and other adjustments	–	212	20	726	958
At 31 December 2016	–	2,669	181	5,299	8,149

¹ Since 2009, the Company has had in issue 100 6% non-cumulative preference shares of £1 each and the Company's subsidiary, Bank of Scotland plc, has had in issue 400 6% non-cumulative preference shares of 25p each.

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33 Subordinated liabilities (continued)

The Company	Preference shares ¹ £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2015	–	95	1,408	5,608	7,111
Repurchases and redemptions during the year:					
4.875% Subordinated Notes 2015	–	–	–	(723)	(723)
6.05% Fixed to Floating Rate Undated Subordinated Notes	–	–	(18)	–	(18)
5.125% Undated Subordinated Fixed to Floating Rate Notes	–	–	(50)	–	(50)
5.109% Callable Fixed to Floating Rate Notes 2017	–	–	–	(14)	(14)
6.305% Subordinated Callable Fixed to Floating Notes 2017	–	–	–	(35)	(35)
Floating Rate Undated Subordinated Step-up Notes	–	–	(29)	–	(29)
6% Subordinated Notes 2033	–	–	–	(194)	(194)
	–	–	(97)	(966)	(1,063)
Exchange and other adjustments	–	(8)	24	(106)	(90)
At 31 December 2015	–	87	1,335	4,536	5,958
Repurchases and redemptions during the year:					
7.5% Undated Subordinated Step-up Notes	–	–	(5)	–	(5)
Callable Floating Rate Subordinated Notes 2016 (callable March 2016)	–	–	–	(186)	(186)
Callable Floating Rate Subordinated Notes 2016 (callable September 2016)	–	–	–	(144)	(144)
Subordinated Callable Notes 2016	–	–	–	(382)	(382)
4.939% Non-voting Non-cumulative Perpetual Preferred Securities	–	(29)	–	–	(29)
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019	–	–	(4)	–	(4)
	–	(29)	(9)	(712)	(750)
Exchange and other adjustments	–	53	108	763	924
At 31 December 2016	–	111	1,434	4,587	6,132

¹ Since 2009, the Company has had in issue 100 6% non-cumulative preference shares of £1 each.

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of the specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of the holders of the dated subordinated liabilities. Neither the Group nor the Company has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2015: none).

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34 Share capital

(1) Authorised share capital

	Group and Company			
	2016 Number of shares	2015 Number of shares	2016 £m	2015 £m
<i>Sterling</i>				
Ordinary shares of 25p	15,139,999,999	15,139,999,999	3,785	3,785
6.125% non-cumulative redeemable preference shares of £1	200,000,000	200,000,000	200	200
8.117% non-cumulative perpetual preference shares class 'A' of £10 each	250,000	250,000	3	3
7.754% non-cumulative perpetual preference shares class 'B' of £10 each	150,000	150,000	2	2
Preference shares of £1 each	2,596,834,398	2,596,834,398	2,597	2,597
			6,587	6,587
<i>US dollars</i>				
			US\$m	US\$m
Preference shares of US\$1 each	4,997,750,000	4,997,750,000	4,998	4,998
<i>Euro</i>				
			€m	€m
Preference shares of €1 each	3,000,000,000	3,000,000,000	3,000	3,000
<i>Japanese yen</i>				
			¥m	¥m
Preference shares of ¥250 each	400,000,000	400,000,000	100,000	100,000
<i>Canadian dollars</i>				
			CAD\$m	CAD\$m
Preference shares of CAD\$1 each	1,000,000,000	1,000,000,000	1,000	1,000
<i>Australian dollars</i>				
			AUD\$m	AUD\$m
Preference shares of AUD\$1 each	1,000,000,000	1,000,000,000	1,000	1,000

(2) Issued share capital

	Group and Company			
	2016 Number of shares	2015 Number of shares	2016 £m	2015 £m
Issued and fully paid ordinary shares				
Ordinary shares of 25p each				
At 1 January and 31 December	15,053,262,841	15,053,262,841	3,763	3,763
Issued and fully paid preference shares				
Preference shares of £1 each				
At 1 January and 31 December	100	100	-	-
Total share capital at 31 December	15,053,262,941	15,053,262,941	3,763	3,763

Share capital and control

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association, and certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws).

Ordinary shares

The holders of ordinary shares, who held 100 per cent of the total ordinary share capital at 31 December 2016, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares may also receive a dividend (subject to the provisions of the Company's articles of association) and on a winding up may share in the assets of the Company.

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35 Share premium account

	Group and Company	
	2016 £m	2015 £m
At 1 January	–	18,655
Capital restructuring	–	(18,655)
At 31 December	–	–

During 2015 the Company reduced its share premium account by Special Resolution which was confirmed by an order of the Court of Session, Scotland on 11 June 2015. The balance on the share premium account of £18,655 million was transferred to retained profits.

36 Other reserves

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Other reserves comprise:				
Merger and other reserves ¹	10,051	10,051	9,537	9,537
Capital redemption reserve ¹	141	141	141	141
Revaluation reserve in respect of available-for-sale financial assets	139	145	4	–
Cash flow hedging reserve	89	169	–	–
Foreign currency translation reserve	(27)	(27)	–	–
At 31 December	10,393	10,479	9,682	9,678

¹ There were no movements in these reserves in 2015 or 2016.

Movements in other reserves were as follows:

	The Group	
	2016 £m	2015 £m
Revaluation reserve in respect of available-for-sale financial assets		
At 1 January	145	158
Change in fair value of available-for-sale financial assets	94	(16)
Deferred tax	(4)	–
Current tax	(2)	2
	88	(14)
Income statement transfers:		
Disposals (note 8)	(71)	(37)
Deferred tax	(22)	–
Current tax	(2)	–
	(95)	(37)
Impairment	1	38
Deferred tax	–	–
	1	38
At 31 December	139	145

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36 Other reserves (continued)

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Cash flow hedging reserve¹				
At 1 January	169	484	-	-
Change in fair value of hedging derivatives	122	181	-	-
Deferred tax	(29)	(54)	-	-
	93	127	-	-
Income statement transfers	(232)	(554)	-	-
Deferred tax	59	112	-	-
	(173)	(442)	-	-
At 31 December	89	169	-	-

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Foreign currency translation reserve				
At 1 January	(27)	(97)	-	15
Currency translation differences arising in the year	(25)	63	-	(15)
Foreign currency gains on net investment hedges (tax: £nil)	25	7	-	-
At 31 December	(27)	(27)	-	-

37 Retained profits

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
At 1 January	(298)	(9,437)	8,992	(7,520)
Profit for the year ¹	2,505	2,011	3,899	9,398
Tax relief on distributions to non-controlling interests	28	-	-	-
Capital restructuring	-	18,655	-	18,655
Dividends paid (note 38)	(2,610)	(11,500)	(2,610)	(11,500)
Capital contribution received	82	89	82	101
Post-retirement defined benefit scheme remeasurement	(565)	(116)	(545)	(142)
At 31 December	(858)	(298)	9,818	8,992

¹ No income statement has been shown for the Company as permitted by section 408 of the Companies Act 2006.

38 Dividends

Dividends paid in the year were as follows:

	2016 £m	2015 £m
Final dividend for previous year paid during the current year	-	-
Interim dividends	2,610	11,500
	2,610	11,500

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39 Share-based payments

During the year ended 31 December 2016 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the HBOS Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group plc are set out below; these are managed and operated on a Lloyds Banking Group-wide basis. The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 9), was £110 million (2015: £144 million).

Deferred bonus plans

The Group operates a number of deferred bonus plans that are equity settled. Bonuses in respect of employee performance in 2016 have been recognised in the charge in line with the proportion of the deferral period completed.

Save-As-You-Earn schemes

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £500 per month and, at the expiry of a fixed term of three or five years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

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

	2016		2015	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	850,146,220	50.99	783,626,383	48.73
Granted	454,667,560	47.49	156,797,949	60.70
Exercised	(401,286,043)	40.74	(32,683,177)	41.83
Forfeited	(10,590,490)	56.02	(27,740,207)	48.69
Cancelled	(204,238,535)	60.23	(24,943,674)	56.04
Expired	(10,005,816)	57.08	(4,911,054)	48.34
Outstanding at 31 December	678,692,896	51.76	850,146,220	50.99
Exercisable at 31 December	–	–	533,654	180.66

The weighted average share price at the time that the options were exercised during 2016 was £0.67 (2015: £0.77). The weighted average remaining contractual life of options outstanding at the end of the year was 2.9 years (2015: 1.9 years).

The weighted average fair value of SAYE options granted during 2016 was £0.13 (2015: £0.17). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2015 or 2016 and the outstanding options lapsed on 31 December 2016. The options outstanding at 31 December 2015 had an exercise price of £1.8066 and a weighted average remaining contractual life of 0.4 years.

Other share option plans

Lloyds Banking Group Executive Share Plan 2003

The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan is used not only to compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

For options granted on 27 March 2014 under the Commercial Banking Transformation Plan (CBTP), the number of options that may be delivered in March 2017 may vary by a factor of 0-4 from the original 'on-target' award, depending on the degree to which the performance conditions have been met. An 'on-target' vesting is contingent upon Commercial Banking achieving £2.5 billion underlying profit and 2 per cent Return on Risk-weighted Assets ('RoRWA') on 31 December 2016. The Plan will pay out at between £1.9 billion and £3 billion underlying profit, and between 1.6 per cent and 2.5 per cent RoRWA.

Participants are not entitled to any dividends paid during the vesting period:

	2016		2015	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	221,397,597	Nil	233,389,084	Nil
Granted	4,298,701	Nil	9,813,363	Nil
Exercised	(2,700,679)	Nil	(13,313,421)	Nil
Forfeited	(3,863,477)	Nil	(8,374,250)	Nil
Lapsed	(169,861)	Nil	(117,179)	Nil
Outstanding at 31 December	218,962,281	Nil	221,397,597	Nil
Exercisable at 31 December	4,504,392	Nil	3,972,911	Nil

The weighted average fair value of options granted in the year was £0.68 (2015: £0.75). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2016 was £0.64 (2015: £0.83). The weighted average remaining contractual life of options outstanding at the end of the year was 5.1 years (2015: 6.1 years).

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39 Share-based payments (continued)

Other share plans

Lloyds Banking Group Long-Term Incentive Plan

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

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares.

At the end of the performance period for the 2013 grant, the targets had not been fully met and therefore these awards vested in 2016 at a rate of 94.18 per cent.

	2016 Number of shares	2015 Number of shares
Outstanding at 1 January	398,066,746	522,836,111
Granted	132,194,032	121,676,131
Vested	(140,879,465)	(196,193,904)
Forfeited	(33,713,900)	(50,251,592)
Dividend award	2,560,615	-
Outstanding at 31 December	358,228,028	398,066,746

Awards in respect of the 2014 grant will vest in 2017 at a rate of 55 per cent.

The weighted average fair value of awards granted in the year was £0.64 (2015: £0.78).

The fair value calculations at 31 December 2016 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	Save-As-You-Earn	Executive Share Plan 2003	LTIP	Commercial Banking Transformation Plan
Weighted average risk-free interest rate	0.25%	0.36%	0.39%	0.43%
Weighted average expected life	3.2 years	1.9 years	3.0 years	0.8 years
Weighted average expected volatility	30%	26%	24%	33%
Weighted average expected dividend yield	4.5%	3.1%	0.0%	4.5%
Weighted average share price	£0.59	£0.69	£0.73	£0.78
Weighted average exercise price	£0.47	nil	nil	nil

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

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £45 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2016 was 35,956,224 (2015: 18,001,413), with an average fair value of £0.61 (2015: £0.78), based on market prices at the date of award.

Fixed share awards

Fixed share awards were introduced in 2014 in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for certain Lloyds Banking Group employees, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements. The fixed share awards are delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The number of shares purchased in 2016 was 10,031,272 (2015: 8,237,469).

The fixed share award is not subject to any performance conditions, performance adjustment or clawback. On an employee leaving the Group, there is no change to the timeline for which shares will become unrestricted.

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40 Related party transactions

Key management personnel

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

The table below details, on an aggregated basis, key management personnel compensation which has been allocated to the Company on an estimated basis.

	2016 £m	2015 £m
Compensation		
Salaries and other short-term benefits	9	7
Post-employment benefits	—	—
Share-based payments	12	9
Total compensation	21	16

The aggregate of the emoluments of the directors was £6.8 million (2015: £5.5 million).

Aggregate company contributions in respect of directors to defined contribution pension schemes were £0.1 million (2015: 0.1 million).

The total for the highest paid director (António Horta-Osório) was £3,144,000 (2015: (António Horta-Osório) £2,581,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

	2016 million	2015 million
Share options over Lloyds Banking Group plc shares		
At 1 January	9	13
Granted (includes entitlement of appointed key management personnel)	3	3
Exercised/lapsed (includes entitlements of former key management personnel)	(9)	(7)
At 31 December	3	9

	2016 million	2015 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January	82	102
Granted (includes entitlements of appointed key management personnel)	29	37
Exercised/lapsed (includes entitlements of former key management personnel)	(46)	(57)
At 31 December	65	82

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

	2016 £m	2015 £m
Loans		
At 1 January	5	3
Advanced (includes loans of appointed key management personnel)	3	4
Repayments (includes loans of former key management personnel)	(4)	(2)
At 31 December	4	5

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 2.49 per cent and 23.95 per cent in 2016 (2015: 3.99 per cent and 23.95 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2015: £nil).

	2016 £m	2015 £m
Deposits		
At 1 January	13	16
Placed (includes deposits of appointed key management personnel)	41	58
Withdrawn (includes deposits of former key management personnel)	(42)	(61)
At 31 December	12	13

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40 Related party transactions (continued)

Deposits placed by key management personnel attracted interest rates of up to 4.0 per cent in 2016 (2015: 4.7 per cent).

At 31 December 2016, the Group did not provide any guarantees in respect of key management personnel (2015: none).

At 31 December 2016, transactions, arrangements and agreements entered into by the Lloyds Banking Group's banking subsidiaries with directors and connected persons of the Group included amounts outstanding in respect of loans and credit card transactions of £0.4 million with five directors and two connected persons. (2015: £1 million with four directors and six connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings

Balances and transactions between members of the HBOS group

In accordance with IFRS 10 *Consolidated financial statements*, transactions and balances between the Company and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Company has a significant number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Company as follows:

	2016 £m	2015 £m
Assets, included within:		
Amounts owed by Group entities	12,496	14,105
Derivative financial instruments	499	586
	12,995	14,691
Liabilities, included within:		
Amounts owed to Group entities	6,382	7,819
Subordinated liabilities	2,025	1,867
	8,407	9,686

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2016 the Company earned interest income on the above asset balances of £423 million (2015: £467 million) and incurred interest expense on the above liability balances of £204 million (2015: £205 million).

Balances and transactions with Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group

The Company and its subsidiaries have balances due to and from the Company's ultimate parent company, Lloyds Banking Group plc, and fellow subsidiaries of the Lloyds Banking Group. These are included on the balance sheet as follows:

	The Group		The Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Assets included within:				
Derivative financial instruments	8,502	9,206	–	–
Loans and receivables	46,911	31,560	604	605
Trading and other financial assets at fair value through profit or loss	2,278	5,602	1,334	1,371
	57,691	46,368	1,938	1,976
Liabilities included within:				
Deposits from banks and customers	99,581	80,047	773	2,467
Derivative financial instruments	9,622	9,507	–	–
Subordinated liabilities	383	465	3	19
Trading financial assets	943	4,112	–	–
Other liabilities	139	598	–	–
	110,668	94,729	776	2,486

These balances include Lloyds Banking Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2016 the Group earned £294 million and the Company earned £22 million of interest income on the above asset balances (2015: Group: £382 million; Company: £25 million); the Group incurred £1,759 million and the Company incurred £42 million of interest expense on the above liability balances (2015: Group: £1,820 million; Company: £71 million).

During the year, certain subsidiaries and fellow Lloyds Banking Group undertakings incurred expenditure for the benefit of the Group's subsidiary, Bank of Scotland plc, which has not been recharged to Bank of Scotland plc; and Bank of Scotland plc incurred expenditure for the benefit of certain Group subsidiaries and fellow Lloyds Banking Group undertakings, which has not been recharged to those entities.

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40 Related party transactions (continued)

Other related party disclosures

Pension funds

At 31 December 2016 there were customer deposits of £34 million (2015: £24 million) related to the Group's pension arrangements.

Joint ventures and associates

At 31 December 2016 there were loans and advances to customers of £173 million (2015: £225 million) outstanding and balances within customer deposits of £15 million (2015: £8 million) relating to joint ventures and associates.

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2016, these companies had total assets of approximately £20 million (2015: £54 million), total liabilities of approximately £80 million (2015: £103 million) and for the year ended 31 December 2016 had turnover of approximately £8 million (2015: £114 million) and made a net profit of approximately £5 million (2015: net loss of approximately £3 million). In addition, the Group has provided £6 million (2015: £15 million) of financing to these companies on which it received approximately £0.1 million (2015: £0.5 million) of interest income in the year.

41 Contingent liabilities and commitments

Interchange fees

With respect to multi-lateral interchange fees (MIFs), the Lloyds Banking Group is not directly involved in the ongoing investigations and litigation (as described below) which involve card schemes such as Visa and MasterCard. However, the Lloyds Banking Group is a member of Visa and MasterCard and other card schemes.

- The European Commission continues to pursue certain competition investigations into MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA;
- Litigation continues in the English Courts against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs. From publicly available information, it is understood these damages claims are running to different timescales with respect to the litigation process. It is also possible that new claims may be issued.
- Any ultimate impact on the Lloyds Banking Group of the above investigations and the litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. The Lloyds Banking Group's share of the sale proceeds comprised cash consideration of approximately £330 million (of which approximately £300 million was received on completion of the sale and £30 million is deferred for three years) and preferred stock, which the Lloyds Banking Group measures at fair value. The preferred stock is convertible into Class A Common Stock of Visa Inc or its equivalent upon the occurrence of certain events. As part of this transaction, the Lloyds Banking Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. The maximum amount of liability to which the Lloyds Banking Group may be subject under the LSA is capped at the cash consideration which was received by the Lloyds Banking Group at completion. Visa Inc may also have recourse to a general indemnity, currently in place under Visa Europe's Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR and other trading rates

In July 2014, the Lloyds Banking Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Lloyds Banking Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The Lloyds Banking Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the Swiss Competition Commission, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

Certain Lloyds Banking Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. The lawsuits, which contain broadly similar allegations, allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act and the Commodity Exchange Act, as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims, including those asserted under US anti-trust laws, were dismissed by the US Federal Court for Southern District of New York (the District Court). In November 2015 OTC and exchange-based plaintiffs' claims against the Lloyds Banking Group were dismissed for lack of personal jurisdiction. On 20 December 2016, the Federal Court for Southern District of New York dismissed all antitrust class action claims against LBG and its affiliates in the Multi District Litigation arising from the alleged manipulation of USD LIBOR. Further appeals in relation to the anti-trust claims remain possible.

Certain Lloyds Banking Group companies are also named as defendants in UK based claims raising LIBOR manipulation allegations in connection with interest rate hedging products.

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking Group of the various outstanding regulatory investigations not encompassed by the settlements, any private lawsuits or any related challenges to the interpretation or validity of any of the Lloyds Banking Group's contractual arrangements, including their timing and scale.

UK shareholder litigation

In August 2014, the Lloyds Banking Group and a number of former directors were named as defendants in a claim filed in the English High Court by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. It is currently not possible to determine the ultimate impact on the Lloyds Banking Group (if any), but the Lloyds Banking Group intends to defend the claim vigorously.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

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41 Contingent liabilities and commitments (continued)

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. At 31 March 2016, the end of the latest FSCS scheme year for which it has published accounts, the principal balance outstanding on these loans was £15,655 million (31 March 2015: £15,797 million). Although it is anticipated that the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants of the FSCS. The amount of future levies payable by the Lloyds Banking Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Lloyds Banking Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

Tax authorities

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities including open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law. The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Lloyds Banking Group's deferred tax asset of approximately £400 million (overall impact on the Group of £350 million). The Lloyds Banking Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due. There are a number of other open matters on which the Group is in discussion with HMRC; none of these is expected to have a material impact on the financial position of the Group.

Residential mortgage repossessions

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases concerning certain aspects of the Lloyds Banking Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA is actively engaged with the industry in relation to these considerations. The Lloyds Banking Group will respond as appropriate to this and any investigations, proceedings, or regulatory action that may in due course be instigated as a result of these issues. The FCA has issued a consultation on new guidance on the treatment of customers with mortgage payment shortfalls. The guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers' monthly mortgage instalments. The output from this consultation is expected in the first quarter of 2017.

Update to the Financial Conduct Authority's announcement in November 2015 on a deadline for PPI complaints and Plevin v Paragon Personal Finance Limited

On 2 August 2016, the Financial Conduct Authority (FCA) published a further consultation paper (CP16/20: Rules and guidance on payment protection insurance complaints: feedback on CP15/39 and further consultation), following on from the original consultation published in November 2015. The consultation papers proposed the introduction of a two year deadline by which consumers would need to make their PPI complaints and the rules and guidance that should apply when firms handle PPI complaints in light of the Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61. On 2 March 2017 the FCA confirmed that the deadline would be 29 August 2019, and new rules for Plevin would come into force in August 2017.

Mortgage arrears handling activities

On 26 May 2016, the Lloyds Banking Group was informed that an enforcement team at the FCA had commenced an investigation in connection with the Lloyds Banking Group's mortgage arrears handling activities. This investigation is ongoing and it is currently not possible to make a reliable assessment of the liability, if any, that may result from the investigation.

HBOS Reading – customer review

The Lloyds Banking Group is commencing a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Lloyds Banking Group in 2009. The review is at an early stage and it is currently not possible to determine the ultimate financial impact on the Lloyds Banking Group.

Other legal actions and regulatory matters

In addition, during the ordinary course of business the Lloyds Banking Group is subject to other complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, challenges, investigations and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Lloyds Banking 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 at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed properly to assess the merits of the case, and no provisions are held in relation to such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

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41 Contingent liabilities and commitments (continued)

Contingent liabilities and commitments arising from the banking business

	The Group	
	2016 £m	2015 £m
Contingent liabilities		
Acceptances and endorsements	1	-
Other:		
Other items serving as direct credit substitutes	19	15
Performance bonds and other transaction-related contingencies	83	90
	102	105
Total contingent liabilities	103	105

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

	The Group	
	2016 £m	2015 £m
Commitments		
Forward asset purchases and forward deposits placed	28	23
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	9,828	9,092
Other commitments	21,817	21,099
	31,645	30,191
1 year or over original maturity	3,651	3,992
Total commitments	35,324	34,206

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £14,431 million (2015: £13,592 million) was irrevocable.

Operating lease commitments

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

	2016 £m	2015 £m
Not later than 1 year	105	114
Later than 1 year and not later than 5 years	332	362
Later than 5 years	431	461
Total operating lease commitments	868	937

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

Capital commitments

Excluding commitments of the Group in respect of investment property (see note 23), there was no capital expenditure contracted but not provided for at 31 December 2016 (2015: £nil).

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42 Financial instruments

(1) Measurement basis of financial assets and liabilities

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

The Group	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
At 31 December 2016							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,840	2,840
Items in the course of collection from banks	–	–	–	–	–	188	188
Trading and other financial assets at fair value through profit or loss	–	943	1,454	–	–	–	2,397
Derivative financial instruments	4,313	10,351	–	–	–	–	14,664
Loans and receivables:							
Loans and advances to banks	–	–	–	–	1,116	–	1,116
Loans and advances to customers	–	–	–	–	268,899	–	268,899
Debt securities	–	–	–	–	169	–	169
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	46,911	–	46,911
	–	–	–	–	317,095	–	317,095
Available-for-sale financial assets	–	–	–	3,034	–	–	3,034
Total financial assets	4,313	11,294	1,454	3,034	317,095	3,028	340,218
Financial liabilities							
Deposits from banks	–	–	–	–	–	6,191	6,191
Customer deposits	–	–	–	–	–	179,317	179,317
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	99,581	99,581
Items in course of transmission to banks	–	–	–	–	–	248	248
Trading and other financial liabilities at fair value through profit or loss	–	943	2	–	–	–	945
Derivative financial instruments	2,168	11,057	–	–	–	–	13,225
Notes in circulation	–	–	–	–	–	1,402	1,402
Debt securities in issue	–	–	–	–	–	16,679	16,679
Subordinated liabilities	–	–	–	–	–	8,149	8,149
Total financial liabilities	2,168	12,000	2	–	–	311,567	325,737

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42 Financial instruments (continued)

The Group	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
At 31 December 2015							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	2,481	2,481
Items in the course of collection from banks	-	-	-	-	-	172	172
Trading and other financial assets at fair value through profit or loss	-	4,230	1,598	-	-	-	5,828
Derivative financial instruments	4,208	10,718	-	-	-	-	14,926
Loans and receivables:							
Loans and advances to banks	-	-	-	-	691	-	691
Loans and advances to customers	-	-	-	-	270,837	-	270,837
Debt securities	-	-	-	-	182	-	182
Due from fellow Lloyds Banking Group undertakings	-	-	-	-	31,560	-	31,560
	-	-	-	-	303,270	-	303,270
Available-for-sale financial assets	-	-	-	4,557	-	-	4,557
Total financial assets	4,208	14,948	1,598	4,557	303,270	2,653	331,234

Financial liabilities							
Deposits from banks	-	-	-	-	-	1,541	1,541
Customer deposits	-	-	-	-	-	190,046	190,046
Due to fellow Lloyds Banking Group undertakings	-	-	-	-	-	80,047	80,047
Items in course of transmission to banks	-	-	-	-	-	342	342
Trading and other financial liabilities at fair value through profit or loss	-	4,414	1	-	-	-	4,415
Derivative financial instruments	2,102	10,642	-	-	-	-	12,744
Notes in circulation	-	-	-	-	-	1,112	1,112
Debt securities in issue	-	-	-	-	-	18,492	18,492
Subordinated liabilities	-	-	-	-	-	8,304	8,304
Total financial liabilities	2,102	15,056	1	-	-	299,884	317,043

The Company	Derivatives held for trading, at fair value through profit or loss £m	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Loans and receivables £m	Available-for-sale £m	Held at amortised cost £m	Total £m
At 31 December 2016						
Financial assets						
Derivative financial instruments	4	495	–	–	–	499
Loans and receivables:						
Amounts due from fellow Lloyds Banking Group undertakings	–	–	14,434	–	–	14,434
Available-for-sale financial assets	–	–	–	4	–	4
Total financial assets	4	495	14,434	4	–	14,937
Financial liabilities						
Amounts owed to fellow Lloyds Banking Group undertakings	–	–	–	–	7,155	7,155
Subordinated liabilities	–	–	–	–	6,132	6,132
Total financial liabilities	–	–	–	–	13,287	13,287

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42 Financial instruments (continued)

The Company	Derivatives held for trading, at fair value through profit or loss £m	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2015					
Financial assets					
Derivative financial instruments	29	557	–	–	586
Loans and receivables:					
Amounts due from fellow Lloyds Banking Group undertakings	–	–	16,082	–	16,082
Total financial assets	29	557	16,082	–	16,668
Financial liabilities					
Amounts owed to fellow Lloyds Banking Group undertakings	–	–	–	10,286	10,286
Subordinated liabilities	–	–	–	5,958	5,958
Total financial liabilities	–	–	–	16,244	16,244

Interest rate risk and currency risk

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

The Company has entered into interest rate and currency swaps with its subsidiary, Bank of Scotland plc, to manage these risks.

Credit risk

The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary and subsidiaries of that company.

(2) Fair value measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a measure as at a specific date and may be significantly different from the amount which will actually be paid or received on maturity or settlement date.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

The carrying amount of the following financial instruments is a reasonable approximation of fair value: cash and balances at central banks, items in the course of collection from banks, items in course of transmission to banks and notes in circulation.

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

Fair value information is not provided for items that are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

Valuation control framework

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

Valuation of financial assets and liabilities

Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

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42 Financial instruments (continued)

Level 1

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise equity shares, treasury bills and other government securities.

Level 2

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

Level 3

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

(3) Financial assets and liabilities carried at fair value

Critical accounting estimates and judgments

The valuation techniques for level 2 and, particularly, level 3 financial instruments involve management judgement and estimates the extent of which depends on the complexity of the instrument and the availability of market observable information. In addition, in line with market practice, the Group applies credit, debit and funding valuation adjustments in determining the fair value of its uncollateralised derivative positions. A description of these adjustments is set out in this note on page 74. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out below.

(A) Financial assets, excluding derivatives

Valuation hierarchy

At 31 December 2016, the Group's financial assets carried at fair value, excluding derivatives, totalled £5,431 million (31 December 2015: £10,385 million). The table below analyses these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described above). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

Valuation hierarchy

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2016				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	943	–	943
Corporate and other debt securities	–	1,335	–	1,335
Equity shares	–	–	119	119
Total trading and other financial assets at fair value through profit or loss	–	2,278	119	2,397
Available-for-sale financial assets				
Debt securities:				
Government securities	114	2	–	116
Bank and building society certificates of deposit	–	–	–	–
Mortgage-backed securities	–	13	–	13
Corporate and other debt securities	–	2,424	–	2,424
	114	2,439	–	2,553
Equity shares	–	12	469	481
Total available-for-sale financial assets	114	2,451	469	3,034
Total financial assets carried at fair value, excluding derivatives	114	4,729	588	5,431

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42 Financial instruments (continued)

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2015				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	4,230	–	4,230
Corporate and other debt securities	–	1,372	–	1,372
Equity shares	–	–	226	226
Total trading and other financial assets at fair value through profit or loss	–	5,602	226	5,828
Available-for-sale financial assets				
Debt securities:				
Government securities	96	–	–	96
Bank and building society certificates of deposit	–	17	–	17
Mortgage-backed securities	–	82	–	82
Corporate and other debt securities	–	3,984	–	3,984
	96	4,083	–	4,179
Equity shares	1	38	339	378
Total available-for-sale financial assets	97	4,121	339	4,557
Total financial assets carried at fair value, excluding derivatives	97	9,723	565	10,385

Movements in level 3 portfolio

The table below analyses movements in level 3 financial assets, excluding derivatives, carried at fair value (recurring measurement):

The Group	2016			2015		
	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Total level 3 assets, excluding derivatives, carried at fair value (recurring basis) £m	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Total level 3 assets, excluding derivatives, carried at fair value (recurring basis) £m
At 1 January	226	339	565	172	270	442
Exchange and other adjustments	1	4	5	1	1	2
(Losses) gains recognised in the income statement within other income	(15)	–	(15)	87	–	87
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	–	32	32	–	11	11
Purchases	–	102	102	1	68	69
Sales	(93)	(39)	(132)	(35)	(11)	(46)
Transfers into the level 3 portfolio	–	31	31	–	–	–
At 31 December	119	469	588	226	339	565
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	64	–	64	92	–	92

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42 Financial instruments (continued)

Valuation methodology for financial assets, excluding derivatives

Loans and advances to customers and banks

These assets are principally reverse repurchase agreements. The fair value of these assets is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security purchased under the reserve repurchase agreement.

Debt securities

Debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

Equity investments

Unlisted equity and fund investments are valued using different techniques in accordance with the Group's valuation policy and International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

Unlisted equity investments and investments in property partnerships held in the life assurance funds are valued using third party valuations. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

(B) Financial liabilities, excluding derivatives

Valuation hierarchy

At 31 December 2016, the Group's financial liabilities carried at fair value, excluding derivatives, comprised its trading and other financial liabilities at fair value through profit or loss and totalled £945 million (31 December 2015: £4,415 million) (Financial guarantees are also recognised at fair value, on initial recognition, and are classified as level 3; but the balance is not material). The table below analyses these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 70). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

The table below analyses movements in the level 3 financial liabilities portfolio, excluding derivatives:

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2016				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	-	-	2	2
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	-	943	-	943
Short positions in securities	-	-	-	-
	-	943	-	943
Total financial liabilities carried at fair value, excluding derivatives	-	943	2	945
At 31 December 2015				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	-	-	1	1
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	-	4,414	-	4,414
Short positions in securities	-	-	-	-
	-	4,414	-	4,414
Total financial liabilities carried at fair value, excluding derivatives	-	4,414	1	4,415

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42 Financial instruments (continued)

The table below analyses movements in the level 3 financial liabilities portfolio, excluding derivatives:

Group	2016 £m	2015 £m
At 1 January	1	5
Losses recognised in the income statement within other income	1	–
Redemptions	–	(4)
At 31 December	2	1
Losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December	1	–

Valuation methodology for financial liabilities, excluding derivatives

Trading liabilities in respect of securities sold under repurchase agreements

The fair value of these liabilities is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security sold under the repurchase agreement.

(C) Derivatives

All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2016, such assets totalled £14,664 million (31 December 2015: £14,926 million) and liabilities totalled £13,225 million (31 December 2015: £12,744 million). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 70). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

The Group	2016				2015			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Derivative assets	–	14,081	583	14,664	–	14,584	342	14,926
Derivative liabilities	–	(13,168)	(57)	(13,225)	–	(12,706)	(38)	(12,744)

Derivatives

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
- Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

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42 Financial instruments (continued)

The table below analyses movements in level 3 derivative assets and liabilities carried at fair value. Following changes in the valuation methodology in 2015, uncollateralised inflation swaps are considered not to have significant unobservable inputs and have been transferred from level 3 to level 2.

The Group	2016		2015	
	Derivative assets £m	Derivative liabilities £m	Derivative assets £m	Derivative liabilities £m
At 1 January	342	(38)	522	(101)
Exchange and other adjustments	53	(3)	(19)	–
Gains (losses) recognised in the income statement within other income	144	(16)	22	(6)
(Sales) redemptions	–	–	(51)	29
Transfers into the level 3 portfolio	44	–	–	–
Transfers out of the level 3 portfolio	–	–	(132)	40
At 31 December	583	(57)	342	(38)
Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December	144	(16)	8	(1)

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

(i) *Uncollateralised derivative valuation adjustments, excluding monoline counterparties*

The following table summarises the movement on this valuation adjustment account for the Group during 2016 and 2015.

	2016 £m	2015 £m
At 1 January	191	178
Income statement (credit) charge	111	(14)
Transfers	(16)	27
At 31 December	286	191

Represented by:

	2016 £m	2015 £m
Credit Valuation Adjustment	253	156
Debit Valuation Adjustment	(15)	(10)
Funding Valuation Adjustment	48	45
	286	191

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

The CVA is sensitive to:

- the current size of the mark-to-market position on the uncollateralised asset;
- expectations of future market volatility of the underlying asset; and
- expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £24 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. Where appropriate, the CVA for these products is calculated on an add-on basis (although no such adjustment was required at 31 December 2016).

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42 Financial instruments (continued)

The DVA is sensitive to:

- the current size of the mark-to-market position on the uncollateralised liability;
- expectations of future market volatility of the underlying liability; and
- the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £21 million to £36 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £93 million fall in the overall valuation adjustment to £245 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding uncollateralised derivative positions. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £9 million.

(ii) Market liquidity

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2016, the Group's derivative trading business held mid to bid-offer valuation adjustments of £41 million (2015: £26 million).

(D) Sensitivity of level 3 valuations

			At 31 December 2016			At 31 December 2015		
Valuation techniques	Significant unobservable inputs ¹		Carrying value £m	Effect of reasonably possible alternative assumptions ²		Carrying value £m	Effect of reasonably possible alternative assumptions ²	
				Favourable changes £m	Unfavourable changes £m		Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Equity and venture capital investments	Underlying asset/ net asset value (incl. property prices) ³	n/a	119	6	(10)	226	21	(26)
			119			226		
Available-for-sale financial assets								
Equity and venture capital investments	Underlying asset/ net asset value (incl. property prices) ³	n/a	469	30	(35)	339	25	(27)
			469			339		
Derivative financial assets								
Interest rate derivatives	Option pricing model	Interest rate volatility (0%/115%)	583	(2)	(8)	342	3	(1)
			583			342		
Level 3 financial assets carried at fair value			1,171			907		
Trading and other financial liabilities at fair value through profit and loss			2	–	–	1	–	–
Derivative financial liabilities								
Interest rate derivatives	Option pricing model	Interest rate volatility (0%/115%)	57	–	–	38	–	–
			57			38		
Level 3 financial liabilities carried at fair value			59			39		

¹ Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

² Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

³ Underlying asset/net asset values represented fair value.

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42 Financial instruments (continued)

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are as follows:

- Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.
- Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.
- Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.
- Earnings multiples are used to value certain unlisted equity investments; a higher earnings multiple will result in a higher fair value.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

Debt securities

Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

Derivatives

Reasonably possible alternative assumptions have been determined in respect of swaptions in the Group's derivative portfolios which are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range of 0 per cent to 115 per cent (2015: 1 per cent and 63 per cent).

Unlisted equity, venture capital investments and investments in property partnerships

The valuation techniques used for unlisted equity and venture capital investments vary depending on the nature of the investment. Reasonably possible alternative valuations for these investments have been calculated by reference to the approach taken, as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

- for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;
- the discount rates used in discounted cash flow valuations; and
- in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

(4) Financial assets and liabilities carried at amortised cost

(A) Financial assets

Valuation hierarchy

The table below analyses the fair values of the financial assets of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 70). Loans and receivables are mainly classified as level 3 due to significant unobservable inputs used in the valuation models. Where inputs are observable, debt securities are classified as level 1 or 2.

The Group	Carrying value £m	Fair value £m	Valuation hierarchy		
			Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2016					
Loans and receivables:					
Loans and advances to customers	268,899	270,153	–	–	270,153
Loans and advances to banks	1,116	1,115	–	–	1,115
Debt securities	169	152	–	139	13
Due from fellow Lloyds Banking Group undertakings	46,911	46,911	–	–	46,911
Reverse repos included in above amounts:					
Loans and advances to customers	–	–	–	–	–
Loans and advances to banks	–	–	–	–	–
At 31 December 2015					
Loans and receivables:					
Loans and advances to customers	270,837	272,000	–	–	272,000
Loans and advances to banks	691	691	–	–	691
Debt securities	182	160	7	145	8
Due from fellow Lloyds Banking Group undertakings	31,560	31,560	–	–	31,560
Reverse repos included in above amounts:					
Loans and advances to customers	–	–	–	–	–
Loans and advances to banks	–	–	–	–	–

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42 Financial instruments (continued)

Valuation methodology

Loans and advances to customers

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates due to their short term nature. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value.

To determine the fair value of loans and advances to customers, loans are segregated into portfolios of similar characteristics. A number of techniques are used to estimate the fair value of fixed rate lending; these take account of expected credit losses based on historic trends, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is usually estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair value of commercial loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. No adjustment is made to put it in place by the Group to manage its interest rate exposure.

Loans and advances to banks

The carrying value of short dated loans and advances to banks is assumed to be their fair value. The fair value of loans and advances to banks is estimated by discounting the anticipated cash flows at a market discount rate adjusted for the credit spread of the obligor or, where not observable, the credit spread of borrowers of similar credit quality.

Debt securities

The fair values of debt securities, which were previously within assets held for trading and were reclassified to loans and receivables, are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

Reverse repurchase agreements

The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

(B) Financial liabilities

Valuation hierarchy

The table below analyses the fair values of the financial liabilities of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 70).

The Group	Carrying value £m	Fair value £m	Valuation hierarchy		
			Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2016					
Deposits from banks	6,191	6,191	–	6,191	–
Customer deposits	179,317	179,420	–	171,529	7,891
Due to fellow Lloyds Banking Group undertakings	99,581	99,581	–	99,581	–
Debt securities in issue	16,679	16,621	–	16,621	–
Subordinated liabilities	8,149	7,554	–	7,554	–
Repos included in above amounts:					
Deposits from banks	4,521	4,521	–	4,521	–
Customer deposits	–	–	–	–	–
At 31 December 2015					
Deposits from banks	1,541	1,541	–	1,541	–
Customer deposits	190,046	189,764	–	178,702	11,062
Due to fellow Lloyds Banking Group undertakings	80,047	80,047	–	80,047	–
Debt securities in issue	18,492	18,159	–	15,259	2,900
Subordinated liabilities	8,304	7,970	–	7,970	–
Repos included in above amounts:					
Deposits from banks	17	17	–	17	–
Customer deposits	–	–	–	–	–

The carrying amount of items in course of transmission to banks and notes in circulation is a reasonable approximation of fair value.

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42 Financial instruments (continued)

Valuation methodology

Deposits from banks and customer deposits

The fair value of bank and customer deposits repayable on demand is assumed to be equal to their carrying value.

The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Debt securities in issue

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities is calculated based on quoted market prices where available. Where quoted market prices are not available, fair value is estimated using discounted cash flow techniques at a rate which reflects market rates of interest and the Group's own credit spread.

Subordinated liabilities

The fair value of subordinated liabilities is determined by reference to quoted market prices where available or by reference to quoted market prices of similar instruments. Subordinated liabilities are classified as level 2, since the inputs used to determine their fair value are largely observable.

Repurchase agreements

The carrying amount is deemed a reasonable approximation of fair value given the short term nature of these instruments.

(5) Reclassification of financial assets

No financial assets were reclassified in 2015 or 2016.

43 Transfers of financial assets

There were no significant transferred financial assets which were derecognised in their entirety, but with ongoing exposure. Details of transferred financial assets that continue to be recognised in full are as follows.

The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets covered as substantially all of the risks and rewards, including credit, interest rate, prepayment and other price risks are retained by the Group. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 16, included within loans and receivables are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all of a majority of the risks and rewards associated with these loans, including credit, interest rate, prepayment and liquidity risk, they remain on the Group's balance sheet. Assets transferred into the Group's securitisation and covered bond programmes are not available to be used by the Group whilst the assets are within the programmes. However, the Group retains the right to remove loans from the covered bond programmes where they are in excess of the programme's requirements. In addition, where the Group has retained some of the notes issued by securitisation and covered bond programmes, the Group has the ability to sell or pledge these retained notes.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 28). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

	At 31 December 2016		At 31 December 2015	
	Carrying value of transferred assets £m	Carrying value of associated liabilities £m	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
The Group				
Repurchase and securities lending transactions				
Available-for-sale financial assets	-	-	102	17
Loans and receivables:				
Loans and advances to customers	9,916	-	22,170	-
Debt securities classified as loans and receivables	-	-	75	-
Securitisation programmes				
Loans and receivables:				
Loans and advances to customers ¹	34,218	5,562	35,807	6,417

¹The carrying value of associated liabilities for the Group excludes securitisation notes held by the Group of £18,642 million (2015: £19,208 million).

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44 Offsetting of financial assets and liabilities

The following information relates to financial assets and liabilities which have been offset in the balance sheet and those which have not been offset but for which the Group has enforceable master netting agreements or collateral arrangements in place with counterparties.

	Gross amounts of assets and liabilities ¹ £m	Amounts offset in the balance sheet ² £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted ¹		Potential net amounts if offset of related amounts permitted £m
				Cash collateral received/pledged £m	Non-cash collateral received/pledged £m	
At 31 December 2016						
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	1,454	–	1,454	–	–	1,454
Reverse repos	943	–	943	–	(943)	–
	2,397	–	2,397	–	(943)	1,454
Derivative financial instruments	14,664	–	14,664	(1,214)	(1,840)	11,610
Loans and advances to banks:						
Excluding reverse repos	1,116	–	1,116	(443)	–	673
Reverse repos	–	–	–	–	–	–
	1,116	–	1,116	(443)	–	673
Loans and advances to customers:						
Excluding reverse repos	268,899	–	268,899	(159)	(888)	267,852
Reverse repos	–	–	–	–	–	–
	268,899	–	268,899	(159)	(888)	267,852
Debt securities	169	–	169	–	–	169
Available-for-sale financial assets	3,034	–	3,034	–	–	3,034
Financial liabilities						
Deposits from banks:						
Excluding repos	1,670	–	1,670	(1,213)	–	457
Repos	4,521	–	4,521	–	(4,521)	–
	6,191	–	6,191	(1,213)	(4,521)	457
Customer deposits:						
Excluding repos	179,317	–	179,317	(1)	(888)	178,428
Repos	–	–	–	–	–	–
	179,317	–	179,317	(1)	(888)	178,428
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	2	–	2	–	–	2
Repos	943	–	943	–	(943)	–
	945	–	945	–	(943)	2
Derivative financial instruments	13,225	–	13,225	(602)	(2,938)	9,685

¹ After impairment allowance.

² The amounts set off in the balance sheet as shown above represent balances with central clearing houses which meet the criteria for offsetting under IAS 32.

³ The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respect of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

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44 Offsetting of financial assets and liabilities (continued)

At 31 December 2015	Gross amounts of assets and liabilities ¹ £m	Amounts offset in the balance sheet ² £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted ³		Potential net amounts if offset of related amounts permitted £m
				Cash collateral received/pledged £m	Non-cash collateral received/pledged £m	
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	1,598	–	1,598	–	–	1,598
Reverse repos	4,230	–	4,230	–	(4,230)	–
	5,828	–	5,828	–	(4,230)	1,598
Derivative financial instruments	14,926	–	14,926	(1,280)	(1,908)	11,738
Loans and advances to banks:						
Excluding reverse repos	691	–	691	(303)	–	388
Reverse repos	–	–	–	–	–	–
	691	–	691	(303)	–	388
Loans and advances to customers:						
Excluding reverse repos	270,837	–	270,837	(81)	(1,067)	269,689
Reverse repos	–	–	–	–	–	–
	270,837	–	270,837	(81)	(1,067)	269,689
Debt securities	182	–	182	–	–	182
Available-for-sale financial assets	4,557	–	4,557	–	(16)	4,541
Financial liabilities						
Deposits from banks:						
Excluding repos	1,524	–	1,524	(1,220)	–	304
Repos	17	–	17	–	(17)	–
	1,541	–	1,541	(1,220)	(17)	304
Customer deposits:						
Excluding repos	190,046	–	190,046	(60)	(1,067)	188,919
Repos	–	–	–	–	–	–
	190,046	–	190,046	(60)	(1,067)	188,919
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	1	–	1	–	–	1
Repos	4,414	–	4,414	–	(4,414)	–
	4,415	–	4,415	–	(4,414)	1
Derivative financial instruments	12,744	–	12,744	(384)	(1,900)	10,460

¹After impairment allowance.

²The amounts set off in the balance sheet as shown above represent balances with central clearing houses which meet the criteria for offsetting under IAS 32.

³The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respect of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over collateralisation have not been taken into account in the above table.

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45 Financial risk management

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

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and currency risk; and liquidity risk. Qualitative and quantitative information about the Group's management of these risks is given below.

(1) Credit risk

The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems on inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components; (i) the probability of default by the counterparty on its contractual obligations; (ii) the current exposures to the counterparty and their likely future development, from which the Group derives the exposure at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivative based transactions.

A. Maximum credit exposure

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

The Group	At 31 December 2016			At 31 December 2015		
	Maximum exposure £m	Offset ² £m	Net exposure £m	Maximum exposure £m	Offset ² £m	Net exposure £m
Loans and receivables:						
Loans and advances to banks, net ¹	1,116	–	1,116	691	–	691
Loans and advances to customers, net ¹	268,899	(888)	268,011	270,837	(1,067)	269,770
Debt securities, net ¹	169	–	169	182	–	182
	270,184	(888)	269,296	271,710	(1,067)	270,643
Available-for-sale financial assets ³	2,553	–	2,553	4,179	–	4,179
Trading and other financial assets at fair value through profit or loss ³ :						
Loans and advances	943	–	943	4,230	–	4,230
Debt securities, treasury and other bills	1,335	–	1,335	1,372	–	1,372
	2,278	–	2,278	5,602	–	5,602
Derivative assets	14,664	(1,838)	12,826	14,926	(1,898)	13,028
Financial guarantees	207	–	207	229	–	229
Off-balance sheet items:						
Acceptances and endorsements	1	–	1	–	–	–
Other items serving as direct credit substitutes	19	–	19	15	–	15
Performance bonds and other transaction-related contingencies	83	–	83	90	–	90
Irrevocable commitments	14,431	–	14,431	13,592	–	13,592
	14,534	–	14,534	13,697	–	13,697
	304,420	(2,726)	301,694	310,343	(2,965)	307,378

¹ Amounts shown net of related impairment allowances.

² Offset items comprise deposit amounts available for offset, and amounts available for offset under master netting arrangements, that do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

³ Excludes equity shares.

B. Concentrations of exposure

The Group's management of concentration risk includes single name, industry sector and country limits as well as controls over the Group's overall exposure to certain products. Further information on the Group's management of this risk is included within Credit risk on page 4.

At 31 December 2016 the most significant concentrations of exposure were in mortgages (comprising 90 per cent of total loans and advances to customers) and other personal lending (comprising 4 per cent of the total). For further information on concentrations of the Group's loans, refer to note 15.

Following the continuing reduction in the Group's non-UK activities, an analysis of credit risk exposures by geographical region has not been provided.

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45 Financial risk management (continued)

C. Credit quality of assets

Loans and receivables

The analysis of lending between retail and commercial has been prepared based upon the type of exposure. Included within retail are exposures to personal customers and small businesses, whilst included within commercial are exposures to corporate customers and other large institutions.

Loans and advances – The Group

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss ¹ £m
		Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	
31 December 2016						
Neither past due nor impaired	1,110	235,184	10,309	13,466	258,959	943
Past due but not impaired ¹	6	6,358	133	75	6,566	–
Impaired – no provision required	–	392	162	178	732	–
– provision held	–	3,393	300	1,334	5,027	–
Gross	1,116	245,327	10,904	15,053	271,284	943
Allowance for impairment losses (note 18)	–	(1,575)	(179)	(631)	(2,385)	–
Net balance sheet carrying value	1,116				268,899	943
31 December 2015						
Neither past due nor impaired	686	235,356	9,776	15,161	260,293	–
Past due but not impaired	5	7,022	147	132	7,301	–
Impaired – no provision required	–	411	211	546	1,168	–
– provision held	–	3,111	219	1,555	4,885	–
Gross	691	245,900	10,353	17,394	273,647	–
Allowance for impairment losses (note 18)	–	(1,479)	(182)	(1,149)	(2,810)	–
Net balance sheet carrying value	691				270,837	–

¹ Excludes amounts due from fellow Lloyds Banking Group undertakings.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(h). Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £1,459 million (2015: £2,157 million).

Loans and advances which are neither past due nor impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	
31 December 2016						
Good quality	1,067	234,184	8,518	6,849		943
Satisfactory quality	29	797	1,542	4,387		–
Lower quality	3	39	159	2,064		–
Below standard, but not impaired	11	164	90	166		–
Total loans and advances which are neither past due nor impaired	1,110	235,184	10,309	13,466	258,959	943
31 December 2015						
Good quality	655	234,715	8,108	6,188		–
Satisfactory quality	23	509	1,442	4,842		–
Lower quality	4	26	154	3,804		–
Below standard, but not impaired	4	106	72	327		–
Total loans and advances which are neither past due nor impaired	686	235,356	9,776	15,161	260,293	–

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45 Financial risk management (continued)

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

Loans and advances which are past due but not impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Commercial £m		
31 December 2016						
0-30 days	6	3,087	92	52	3,231	–
30-60 days	–	1,357	36	5	1,398	–
60-90 days	–	854	–	2	856	–
90-180 days	–	1,060	1	6	1,067	–
Over 180 days	–	–	4	10	14	–
Total loans and advances which are past due but not impaired	6	6,358	133	75	6,566	–
31 December 2015						
0-30 days	5	3,484	98	66	3,648	–
30-60 days	–	1,464	38	22	1,524	–
60-90 days	–	912	5	11	928	–
90-180 days	–	1,162	1	4	1,167	–
Over 180 days	–	–	5	29	34	–
Total loans and advances which are past due but not impaired	5	7,022	147	132	7,301	–

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

Debt securities classified as loans and receivables – The Group

An analysis by credit rating of debt securities classified as loans and receivables is provided below:

	2016			2015		
	Investment grade ¹ £m	Other ² £m	Total £m	Investment grade ¹ £m	Other ² £m	Total £m
Asset-backed securities:						
Mortgage-backed securities	30	–	30	30	–	30
Other asset-backed securities	122	7	129	135	7	142
	152	7	159	165	7	172
Corporate and other debt securities	22	79	101	–	123	123
Gross exposure	174	86	260	165	130	295
Allowance for impairment losses			(91)			(113)
Total debt securities classified as loans and receivables			169			182

¹ Credit ratings equal to or better than 'BBB'.

² Other comprises sub-investment grade (2016: £nil; 2015: £nil) and not rated (2016: £86 million; 2015: £130 million).

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45 Financial risk management (continued)

Available-for-sale financial assets (excluding equity shares) – The Group

An analysis of available-for-sale financial assets is included in note 19. The credit quality of available-for-sale financial assets (excluding equity shares) is set out below:

	2016			2015		
	Investment grade ¹ £m	Other £m	Total £m	Investment grade ¹ £m	Other £m	Total £m
Debt securities:						
Government securities	116	–	116	96	–	96
Bank and building society certificates of deposit	–	–	–	17	–	17
Asset-backed securities:						
Mortgage-backed securities	13	–	13	82	–	82
Other asset-backed securities	–	–	–	–	–	–
	13	–	13	82	–	82
Corporate and other debt securities	2,424	–	2,424	3,984	–	3,984
	2,553	–	2,553	4,179	–	4,179
Due from fellow Group undertakings			–			–
Total held as available-for-sale financial assets			2,553			4,179

¹ Credit ratings equal to or better than 'BBB'.

Debt securities, treasury and other bills held at fair value through profit or loss – The Group

An analysis of trading and other financial assets at fair value through profit or loss is included in note 12; the debt securities, treasury and other bills held at fair value through profit or loss comprise amounts due from fellow Lloyds Banking Group undertakings of £1,334 million (2015: £nil).

Derivative assets – The Group

An analysis of derivative assets is given in note 13. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's net credit risk relating to derivative assets of £12,826 million (2015: £13,028 million), cash collateral of £1,214 million (2015: £1,280 million) was held and a further £162 million was due from OECD banks (2015: £84 million).

	2016			2015		
	Investment grade ¹ £m	Other ² £m	Total £m	Investment grade ¹ £m	Other ² £m	Total £m
Derivative financial instruments						
Trading and other	4,201	862	5,063	3,945	565	4,510
Hedging	1,099	–	1,099	1,209	1	1,210
	5,300	862	6,162	5,154	566	5,720
Due from fellow Group undertakings			8,502			9,206
Total derivative financial instruments			14,664			14,926

¹ Credit ratings equal to or better than 'BBB'.

² Other comprises sub-investment grade (2016: £862 million; 2015: £564 million) and not rated (2016: £nil; 2015: £2 million).

Financial guarantees and irrevocable loan commitments

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

D. Collateral held as security for financial assets

The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

Loans and receivables

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as loans and receivables.

Loans and advances to banks

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

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45 Financial risk management (continued)

Loans and advances to customers

Retail lending

Mortgages

An analysis by loan-to-value ratio of the Group's residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations.

	2016				2015			
	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
Less than 70 per cent	170,747	4,475	2,053	177,275	159,955	4,135	1,628	165,718
70 per cent to 80 per cent	33,861	908	557	35,326	37,782	1,163	573	39,518
80 per cent to 90 per cent	19,546	569	430	20,545	22,914	804	461	24,179
90 per cent to 100 per cent	6,913	207	301	7,421	9,042	524	330	9,896
Greater than 100 per cent	4,117	199	444	4,760	5,663	396	530	6,589
Total	235,184	6,358	3,785	245,327	235,356	7,022	3,522	245,900

Other

The majority of non-mortgage retail lending is unsecured. At 31 December 2016, impaired non-mortgage lending amounted to £283 million, net of an impairment allowance of £179 million (2015: £247 million net of an impairment allowance of £182 million). The fair value of the collateral held in respect of this lending was £nil (2015: £nil). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £10,442 million (2015: £9,923 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Commercial lending

Impaired secured lending

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2016, impaired secured commercial lending amounted to £552 million, net of an impairment allowance of £293 million (2015: £530 million, net of an impairment allowance of £467 million). The fair value of the collateral held in respect of impaired secured commercial lending was £657 million (2015: £265 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured commercial lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Impaired secured commercial lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

Unimpaired secured lending

Unimpaired secured commercial lending amounted to £6,500 million (2015: £7,111 million).

For unimpaired secured commercial lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

Unimpaired secured commercial lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured commercial lending portfolio is provided to key management personnel.

Trading and other financial assets at fair value through profit or loss (excluding equity shares)

Included in trading and other financial assets at fair value through profit or loss are repurchase agreements treated as collateralised loans with a carrying value of £943 million (2015: £4,230 million). Collateral is held with a fair value of £996 million (2015: £3,794 million), all of which the Group is able to repledge. At 31 December 2016, £996 million had been repledged (2015: £666 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £32,834 (2015: £nil). At 31 December 2016 £2,765 million of this amount had been resold or repledged as collateral for the Group's own transactions (2015: £nil).

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

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45 Financial risk management (continued)

Derivative assets, after offsetting of amounts under master netting arrangements

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £12,826 million (2015: £13,028 million), cash collateral of £1,214 million (2015: £1,280 million) was held.

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2016, there were irrevocable loan commitments and other credit-related contingencies of £14,534 million (2015: £13,697 million). Collateral is held as security, in the event that lending is drawn down, on £10,044 million (2015: £9,551 million) of these balances.

Collateral repossessed

During the year, £213 million of collateral was repossessed (2015: £182 million), consisting primarily of residential property. In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against commercial lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

E. Collateral pledged as security

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

Repurchase transactions

Deposits from banks

Included in deposits from banks are deposits held as collateral for facilities granted, with a carrying value of £4,521 million (2015: £17 million) and a fair value of £5,703 million (2015: £17 million).

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

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowing, where the secured party is permitted by contract or custom to repledge was £943 million (2015: £4,180 million).

Securities lending transactions

The following on balance sheet financial assets have been lent to counterparties under securities lending transactions:

The Group	2016 £m	2015 £m
Loans and advances to customers	–	22,170
Debt securities classified as loans and receivables	–	75
Available-for-sale financial assets	30	86
	30	22,331

Securitisation and covered bonds

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's securitisation and covered bond programmes. Further details of these assets are provided in notes 16 and 17.

(2) Market risk

Interest rate risk

Interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. The rates on the remaining deposits are contractually fixed for their term to maturity.

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

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt.

At 31 December 2016 the aggregate notional principal of interest rate swaps designated as fair value hedges was £16,968 million (2015: £21,646 million) with a net fair value asset of £2,496 million (2015: £2,574 million) (see note 13). The losses on the hedging instruments were £250 million (2015: losses of £459 million). The gains on the hedged items attributable to the hedged risk were £239 million (2015: gains of £457 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the commercial business. These cash flows are expected to occur over the next five years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2016 was £39,525 million (2015: £44,922 million) with a net fair value liability of £351 million (2015: liability of £476 million) (see note 13). In 2016, ineffectiveness recognised in the income statement that arises from cash flow hedges was £nil (2015: £nil).

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45 Financial risk management (continued)

Currency risk

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market and liquidity risk function in London.

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

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using cross currency borrowings. At 31 December 2016 the aggregate principal of these currency borrowings was £135 million (2015: £233 million). In 2016, an ineffectiveness loss of £3 million before tax and £2 million after tax (2015: £1 million gain before and after tax) was recognised in the income statement arising from net investment hedges.

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

Functional currency of Group operations

The Group	Euro £m	US Dollar £m	Other non-sterling £m
31 December 2016			
Gross exposure	30	110	4
Net investment hedge	(25)	(110)	–
Total structural foreign currency exposures, after net investment hedges	5	–	4
31 December 2015			
Gross exposure	102	126	1
Net investment hedge	(101)	(132)	–
Total structural foreign currency exposures, after net investment hedges	1	(6)	1

(3) Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses financial instrument liabilities of the Group on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2016						
Deposits from banks	16	35	10	5,805	326	6,192
Customer deposits	139,084	4,284	18,982	16,891	790	180,031
Trading liabilities	943	–	–	–	2	945
Debt securities in issue	579	2,506	2,597	10,927	920	17,529
Subordinated liabilities	–	441	647	4,134	4,583	9,805
Total non-derivative financial liabilities	140,622	7,266	22,236	37,757	6,621	214,502
Derivative financial liabilities:						
Gross settled derivative – outflow	666	548	543	4,798	4,413	10,968
Gross settled derivative – inflow	(472)	(492)	(520)	(4,601)	(4,082)	(10,167)
Gross settled derivative – netflow	194	56	23	197	331	801
Net settled derivative liabilities	2,510	17	87	210	244	3,068
Total derivative financial liabilities	2,704	73	110	407	575	3,869

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45 Financial risk management (continued)

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2015						
Deposits from banks	36	–	9	1,496	–	1,541
Customer deposits	137,615	7,667	23,898	21,546	901	191,627
Trading liabilities	4,415	–	–	–	1	4,416
Debt securities in issue	503	261	3,441	8,967	7,337	20,509
Subordinated liabilities	120	232	992	4,147	5,593	11,084
Total non-derivative financial liabilities	142,689	8,160	28,340	36,156	13,832	229,177

Derivative financial liabilities:

Gross settled derivative – outflow	169	190	752	2,851	4,263	8,225
Gross settled derivative – inflow	(57)	(150)	(731)	(2,787)	(3,770)	(7,495)
Gross settled derivative – netflow	112	40	21	64	493	730
Net settled derivative liabilities	2,131	27	92	307	360	2,917
Total derivative financial liabilities	2,243	67	113	371	853	3,647

The Company	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2016						
Amounts owed to fellow Group undertakings	–	–	–	–	7,155	7,155
Subordinated liabilities	–	611	790	3,012	2,290	6,703
Total non-derivative financial liabilities	–	611	790	3,012	9,445	13,858

At 31 December 2015

Amounts owed to fellow Group undertakings	–	–	–	–	10,286	10,286
Subordinated liabilities	–	202	643	3,020	2,752	6,617
Total non-derivative financial liabilities	–	202	643	3,020	13,038	16,903

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £207 million at 31 December 2016 (2015: £229 million) with £36 million expiring within one year; £39 million between one and three years; £12 million between three and five years; and £120 million over five years (2015: £39 million expiring within one year; £26 million between one and three years; £30 million between three and five years; and £134 million over five years).

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £7 million (2015: £17 million) for the Group and £1 million (2015: £1 million) for the Company per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

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

The Group	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2016					
Acceptances and endorsements	1	–	–	–	1
Other contingent liabilities	60	16	–	26	102
Total contingent liabilities	61	16	–	26	103
Lending commitments	31,646	1,401	698	1,551	35,296
Other commitments	1	6	10	11	28
Total commitments	31,647	1,407	708	1,562	35,324
Total contingents and commitments	31,708	1,423	708	1,588	35,427

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45 Financial risk management (continued)

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2015					
Acceptances and endorsements	–	–	–	–	–
Other contingent liabilities	84	6	–	15	105
Total contingent liabilities	84	6	–	15	105
Lending commitments	30,114	1,458	666	1,945	34,183
Other commitments	–	–	–	23	23
Total commitments	30,114	1,458	666	1,968	34,206
Total contingents and commitments	30,198	1,464	666	1,983	34,311

46 Capital

Capital management

Within the Group, capital within each regulated entity is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the Lloyds Banking Group Asset and Liability Committee. Capital raised takes account of evolving regulatory requirements, expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

The Group measures the amount of capital it holds using the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA) policy statement PS7/13. Application of CRD IV requirements is subject to transitional phasing permitted by PS7/13.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of the aggregate risk-weighted assets calculated in respect of credit risk, counterparty credit risk, operational risk and market risk. At least 4.5 per cent of risk-weighted assets are required to be covered by Common Equity Tier 1 (CET1) capital.

The minimum requirement for capital is supplemented by Pillar 2 of the framework. Under Pillar 2A, additional requirements are set through the issuance of bank specific Individual Capital Guidance (ICG), which adjusts the Pillar 1 minimum for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICG process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process (ICAAP).

A range of additional bank specific regulatory capital buffers apply under CRD IV. These include a capital conservation buffer of 0.625 per cent of risk-weighted assets (increasing to 2.5 per cent by 2019) and a time-varying countercyclical capital buffer for which the Group currently has a negligible requirement based on its minimal exposures to those jurisdictions that have set countercyclical buffer rates. Other capital buffers do not currently apply to the Group as they are either not applicable or are applied at the discretion of the regulator.

During the year, the individual regulated entities within the Group and the Group itself complied with all of the externally imposed capital requirements to which they are subject.

Regulatory capital developments

The regulatory framework within which the Group operates continues to be developed at a global level through the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS), at a European level mainly through the European Commission (EC) and the issuance of CRD IV technical standards and guidelines by the European Banking Authority (EBA) and within the UK by the PRA and through directions from the Financial Policy Committee (FPC). The Group continues to monitor these developments very closely, analysing potential capital impacts to ensure the Group and individual regulated entities continue to maintain a strong capital position that exceeds the minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

Capital resources

Regulatory capital is divided into tiers depending on the degree of permanency and ability to absorb losses.

- Common equity tier 1 capital represents the strongest form of capital consisting of shareholders' equity after a number of regulatory adjustments and deductions are applied. These include deductions for deferred tax assets, subject to threshold requirements under CRD IV, and the elimination of the cash flow hedging reserve, goodwill, other intangible assets and defined benefit pension surpluses.
- Fully qualifying additional tier 1 (AT1) capital comprises non-cumulative perpetual securities containing specific provisions to write down the security or convert it to equity should the CET1 ratio fall to a defined trigger limit. Under transitional rules, securities that do not qualify in their own right but were issued and eligible as tier 1 capital prior to CRD IV can be partially included within AT1, until they are phased out altogether in 2022. To the extent these securities do not qualify as AT1 they may nevertheless still qualify as tier 2 capital.
- Tier 2 (T2) capital comprises certain other subordinated debt securities that do not qualify as AT1. They must have an original term of at least 5 years, cannot normally be redeemed within their first 5 years and are phased out as T2 regulatory capital in the final 5 years before maturity. Transitional rules under CRD IV allow securities that do not qualify in their own right as T2 capital, but which were issued and eligible as T2 capital prior to CRD IV, to be partially included as T2 capital until they are phased out altogether in 2022.

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46 Capital (continued)

The Group's CRD IV transitional capital resources are summarised as follows:

	2016 £m	2015 £m
Common equity tier 1 capital	9,984	8,765
Additional tier 1 capital	3,042	3,317
Tier 2 capital	3,015	3,290
Total capital	16,041	15,372

47 Cash flow statements

a Change in operating assets

	The Group	
	2016 £m	2015 £m
Change in loans and receivables	3,733	3,456
Change in amounts due from Group undertakings	(15,351)	17,177
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	3,806	18,354
Change in other operating assets	82	1,295
Change in operating assets	(7,730)	40,282

b Change in operating liabilities

	The Group	
	2016 £m	2015 £m
Change in deposits from banks	4,651	(751)
Change in customer deposits	(9,271)	(12,889)
Change in amounts due to Group undertakings	21,219	1,400
Change in debt securities in issue	(1,795)	(1,910)
Change in derivative financial instruments and trading and other financial liabilities at fair value through profit or loss	(2,989)	(17,378)
Change in other operating liabilities	(65)	(643)
Change in operating liabilities	11,750	(32,171)

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47 Cash flow statements (continued)

c Non-cash and other items

	The Group	
	2016 £m	2015 £m
Depreciation and amortisation	172	174
Revaluation of investment properties	(2)	(7)
Allowance for loan losses	216	215
Write-off of allowance for loan losses, net of recoveries	(697)	(2,920)
Impairment of available-for-sale financial assets	1	38
Payment protection insurance provision	266	1,102
Other provision movements	259	208
Net charge (credit) in respect of defined benefit schemes	128	121
Unwind of discount on impairment allowances	11	19
Foreign exchange element on balance sheet ¹	(2,416)	742
Interest expense on subordinated liabilities	415	429
Other non-cash items	(670)	(650)
Total non-cash items	(2,317)	(529)
Contributions to defined benefit schemes	(177)	(153)
Payments in respect of other provision	(58)	(193)
Payments in respect of payment protection insurance provision	(546)	(810)
Other	2	7
Total other items	(779)	(1,149)
Non-cash and other items	(3,096)	(1,678)

¹When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

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

	The Group	
	2016 £m	2015 £m
Cash and balances with central banks	2,840	2,481
Less: mandatory reserve deposits ¹	(455)	(452)
	2,385	2,029
Loans and advances to banks	1,116	691
Less: amounts with a maturity of three months or more	(449)	(328)
	667	363
Total cash and cash equivalents	3,052	2,392

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

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Notes to the accounts

47 Cash flow statements (continued)

e Disposal and closure of group undertakings, joint ventures and associates

	The Group	
	2016 £m	2015 £m
Net assets sold – interests in joint ventures and associates	5	22
Cash consideration received on losing control of group undertakings and businesses	5	22
Cash and cash equivalents disposed	–	–
Net cash inflow	5	22

48 Events since the balance sheet date

On 2 March 2017 the FCA confirmed that the deadline by which consumers will need to make their PPI complaints will be 29 August 2019 and that the final rules and guidance that should apply when firms handle PPI complaints in light of Plevin will come into force in August 2017. The Group has reassessed its provisioning in light of this guidance, leading to an additional charge of £130 million, bringing the total charge for the year ended 31 December 2016 to £266 million.

49 Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2016 and have not been applied in preparing these financial statements. Save as disclosed below, the impact of these accounting changes is still being assessed by the Group and reliable estimates cannot be made at this stage.

With the exception of IFRS 9, which was endorsed in November 2016, as at 20 March 2017 these pronouncements are awaiting EU endorsement.

IFRS 9 Financial Instruments

IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement and is effective for annual periods beginning on or after 1 January 2018.

Classification and Measurement

IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income or amortised cost. Financial assets will be measured at amortised cost if they are held within a business model the objective of which is to hold financial assets in order to collect contractual cash flows, and their contractual cash flows represent solely payments of principal and interest. Financial assets will be measured at fair value through other comprehensive income if they are held within a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets and their contractual cash flows represent solely payments of principal and interest. Financial assets not meeting either of these two business models, and all equity instruments (unless designated at inception to fair value through other comprehensive income); and all derivatives are measured at fair value through profit or loss. An entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch.

The Group has undertaken an assessment to determine the potential impact of changes in classification and measurement of financial assets. The adoption of IFRS 9 is unlikely to result in significant changes to existing asset measurement bases, however, the final impact will be dependent on the facts and circumstances that exist on 1 January 2018.

IFRS 9 retains most of the existing requirements for financial liabilities. However, for financial liabilities designated at fair value through profit or loss, gains or losses attributable to changes in own credit risk may be presented in other comprehensive income. It is expected that the Group will elect to early adopt this presentation of gains and losses on financial liabilities from 1 January 2017. These gains and losses are currently recognised in profit or loss and are disclosed in note 29 to the financial statements.

Impairment Overview

The IFRS 9 impairment model will be applicable to all financial assets at amortised cost, debt instruments measured at fair value through other comprehensive income, lease receivables, loan commitments and financial guarantees not measured at fair value through profit or loss.

IFRS 9 replaces the existing 'incurred loss' impairment approach with an Expected Credit Loss ('ECL') model, resulting in earlier recognition of credit losses compared with IAS 39. Expected credit losses are the unbiased probability weighted average credit losses determined by evaluating a range of possible outcomes and future economic conditions.

The ECL model has three stages. Entities are required to recognise a 12 month expected loss allowance on initial recognition (stage 1) and a lifetime expected loss allowance when there has been a significant increase in credit risk since initial recognition (stage 2). Stage 3 requires objective evidence that an asset is credit-impaired, which is similar to the guidance on incurred losses in IAS 39.

Under IAS 39, provisions are recognised for losses that have been incurred but may not have been separately identified. An assessment is made of the likelihood of assets being impaired at the balance sheet date and being identified subsequently; the length of time taken to identify that an impairment event has occurred is known as the loss emergence period. The Group has a range of emergence periods which are dependent upon the characteristics of the portfolios, but typically range between one month and twelve months based on historical experience. Unsecured portfolios tend to have shorter emergence periods than secured portfolios. Under IFRS 9, all loans in stage 1 will require a loss allowance measured at an amount equal to 12 months ECL and is therefore longer than current emergence periods for certain portfolios.

The requirement to recognise lifetime ECL for loans which have experienced a significant increase in credit risk since origination, but which are not credit impaired, does not exist under IAS 39. The assessment of whether an asset is in stage 1 or 2 considers the relative change in the probability of default occurring over the expected life of the instrument, not the change in the amount of expected credit losses. This will involve setting quantitative tests combined with

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49 Future accounting developments (continued)

supplementary indicators such as credit risk classification. Reasonable and supportable forward looking information will also be used in determining the stage allocation. In general, assets more than 30 days past due, but not credit impaired, will be classed as stage 2.

IFRS 9 requires the use of more forward looking information including reasonable and supportable forecasts of future economic conditions. The need to consider a range of economic scenarios and how they could impact the loss allowance is a subjective feature of the IFRS 9 ECL model. The Group is developing the capability to model a number of economic scenarios and capture the impact on credit losses to ensure the overall ECL represents a reasonable distribution of economic outcomes. Appropriate governance and oversight will be established around the process.

IFRS 9 Impairment Models

For all material portfolios, IFRS 9 ECL calculation will leverage the systems, data and methodology used to calculate regulatory 'expected losses'. The Group anticipates the definition of default for IFRS 9 purposes will be aligned to the Basel definition of default to ensure consistency across the Group. However, the IFRS 9 ECL models differ from the regulatory models in a number of ways, for example stage 2 assets under IFRS 9 carry a lifetime expected loss amount whereas regulatory models generate 12 month expected losses for non-defaulted loans.

IFRS 9 models will use three key input parameters for the computation of expected loss, being probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD'). However, given the conservatism inherent in the regulatory expected losses calculation, some adjustments to these components must be made to ensure compliance with IFRS 9. Some of the key requirements are listed in the following table.

Component	Regulatory capital	IFRS 9
EAD	<ul style="list-style-type: none"> Anticipates additional drawings made by customers who are yet to default Downturn EAD, appropriate to a severe but plausible economic downturn 	<ul style="list-style-type: none"> Maximum exposure is the contractual amount except for certain revolving facilities (as defined by the standard) Forward looking EAD
PD	<ul style="list-style-type: none"> 12 month PD Through-the-cycle using long run average economic and risk data to reduce sensitivity to changes in the economic cycle Default defined as 90 days past due, except 180 days past due definition for certain mortgage portfolios secured by UK residential real estate, plus unlikelihood to pay factors 	<ul style="list-style-type: none"> Forward-looking 12 month PD or lifetime PD, considering a range of possible outcomes Point-in-time, sensitive to changes in the economic cycle No explicit definition of default Rebuttable presumption that default does not occur later than when a financial asset is 90 days past due
LGD	<ul style="list-style-type: none"> Downturn LGD, appropriate to a severe by plausible economic downturn Subject to floors, to mitigate the risk of underestimating credit losses due to a lack of historical data Discount cash flows to take account of the uncertainties associated with the receipt of recoveries with respect to a defaulted exposure 	<ul style="list-style-type: none"> Forward looking LGD No floors prescribed Discount rate is effective interest rate as defined by IFRS 9

Impact of IFRS 9 on the Group

The adoption of IFRS 9 may result in an increase in the Group's balance sheet provisions for credit losses and may therefore negatively impact the Group's regulatory capital position. The extent of any increase in provisions will depend upon a number of factors including the composition of the Group's lending portfolios and forecast economic conditions at the date of implementation. Whilst the Group is still refining its methodology and completing the development of the models required to calculate the provision, it is not possible to provide a reliable estimate of the impact of adopting IFRS 9. It is also too early to estimate the ongoing impact of the IFRS 9 impairment model on the financial results although the requirement to transfer assets between stages and to incorporate forward looking data into the expected credit loss calculation, including multiple economic scenarios, could result in impairment charges being more volatile when compared to the current IAS 39 impairment model.

The regulatory capital impact of IFRS 9 could be affected by changes to the regulatory rules. The Basel Committee on Banking Supervision has issued two papers on the impacts of IFRS 9 on regulatory capital, a consultation paper on the 'Regulatory treatment of accounting provisions – interim approach and transitional arrangements'; and one discussing longer-term changes. It is not clear whether any transitional capital arrangements will be in place for 1 January 2018.

Hedge Accounting

The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The standard does not address macro hedge accounting, which is being considered in a separate IASB project. There is an option to maintain the existing IAS 39 hedge accounting rules until the IASB completes its project on macro hedging. The Group currently expects to continue applying IAS 39 hedge accounting in accordance with this accounting policy choice.

IFRS 9 Implementation Programme

The Group has an established IFRS 9 programme to ensure a high quality implementation in compliance with the standard and additional regulatory guidance that has been issued. The programme involves Finance and Risk functions across the Group with Divisional and Group steering committees providing oversight. The key responsibilities of the programme include defining IFRS 9 methodology and accounting policy, development of ECL models, identifying data and system requirements, and establishing an appropriate operating model and governance framework. The programme is progressing in line with current delivery plans.

Credit risk methodologies have been defined and model build and approval is underway for core portfolios. The Retail secured model has been approved by the Model Governance Committee. Models and credit risk processes will be tested during the parallel run period to embed the changes and help improve the understanding of the new impairment models.

Finance systems and reporting requirements are being developed and tested. Existing controls and governance structures have been reviewed and changes identified as a result of IFRS 9. The governance framework includes the review, challenge and sign-off of forward looking information for a range of economic scenarios. Communication and training plans are in place and the impact on resources within Finance and Risk functions is being assessed to ensure the business is ready to implement the new standard.

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49 Future accounting developments (continued)**IFRS 15 Revenue from Contracts with Customers**

IFRS 15 replaces IAS 18 Revenue and IAS 11 Construction Contracts. Financial instruments and leases are out of scope however, fee recognition associated with credit cards and packaged products, for example, will need to be reviewed. The standard is not currently expected to have a significant impact on the Group's profitability. Limited, or no systems or process impacts are expected as a result of adopting IFRS 15. IFRS 15 is effective for annual periods beginning on or after 1 January 2018.

IFRS 16 Leases

IFRS 16 replaces IAS 17 Leases and requires lessees to recognise a right of use asset and a liability for future payments arising from a lease contract. Lessees will recognise a finance charge on the liability and a depreciation charge on the asset which could affect the timing of the recognition of expenses on leased assets. This change will mainly impact the properties that the Group currently accounts for as operating leases. Finance systems will need to be changed to reflect the new accounting rules and disclosures. Lessor accounting requirements remain aligned to the current approach under IAS 17. IFRS 16 is effective for annual periods beginning on or after 1 January 2019.

Minor amendments to other accounting standards

During 2016, the IASB has issued amendments to IAS 7 Statement of Cash Flows (which require additional disclosure about an entity's financing activities) and IAS 12 Income Taxes (which clarify when a deferred tax asset should be recognised for unrealised losses) together with a number of other minor amendments to IFRSs, which will be effective for annual periods beginning on or after either 1 January 2017 or 1 January 2018. These revised requirements are not expected to have a significant impact on the Group.

50 Other information

HBOS plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and in certain locations overseas.

HBOS plc's immediate parent undertaking is Lloyds Bank plc and its ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

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Group companies

GROUP COMPANIES

In compliance with Section 409 of the Companies Act 2006, the following comprises a list of all related undertakings of the Group, as at 31 December 2016. The list includes each undertaking's registered office and the percentage of the class(es) of shares held by the immediate parent company. Where different, the ultimate percentage of the class of shares held by the Group is given in brackets. All shares held are ordinary shares unless indicated otherwise.

Subsidiary undertakings

The Group holds a majority of the voting rights of the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)	Notes		
ADF No.1 Pty Ltd	100%	5		
Anglo Scottish Utilities Partnership 1	n/a	+		
Automobile Association Personal Finance Ltd	100%	3		
Bank of Scotland (B.G.S) London Nominees Ltd	n/a	4 *		
Bank of Scotland (Stanlife) London Nominees Ltd	n/a	4 *		
Bank of Scotland Branch Nominees Ltd	100%	4		
Bank of Scotland Capital Funding (Jersey) Ltd	100%	6		
Bank of Scotland Capital Funding L.P.	100%	6		
Bank of Scotland Central Nominees Ltd	n/a	4 *		
Bank of Scotland Edinburgh Nominees Ltd	n/a	4 *		
Bank of Scotland Equipment Finance Ltd	100%	2		
Bank of Scotland Hong Kong Nominees Ltd	n/a	7 *		
Bank of Scotland Insurance Services Ltd	99.99% (100%)	4		
Bank of Scotland Leasing Ltd	100%	2		
Bank of Scotland LNG Leasing (No 1) Ltd	100%	1		
Bank of Scotland London Nominees Ltd	n/a	4 *		
Bank of Scotland Nominees (Unit Trusts) Ltd	n/a	4 *		
Bank of Scotland P.E.P. Nominees Ltd	n/a	4 *		
Bank of Scotland plc	99.99% (100%)	4 ^		
	0% (100%)	iv		
Bank of Scotland Structured Asset Finance Ltd	100%	1		
Bank of Scotland Transport Finance 1 Ltd	100%	2		
Bank of Wales Ltd	100%	2		
Barents Leasing Ltd	100%	1		
Bavarian Mortgages No. 5 Ltd (in liquidation)	99.998% (100%)	8		
Birmingham Midshires Asset Management Ltd	100%	3		
Birmingham Midshires Financial Services Ltd	100%	3		
Birmingham Midshires Land Development Ltd	100%	3		
Birmingham Midshires Mortgage Services Ltd	100%	3		
Birmingham Midshires Mortgage Services				
No.1 Ltd (in strike off)	100%	3		
BOS (Ireland) Nominees Ltd (in liquidation)	100%	16		
BOS (Ireland) Property Services 2 Ltd	100%	16		
BOS (PB) LLC	100%	9		
BOS (Shared Appreciation Mortgages (Scotland) No. 2) Ltd	100%	3		
BOS (Shared Appreciation Mortgages (Scotland) No. 3) Ltd	100%	3		
BOS (Shared Appreciation Mortgages (Scotland)) Ltd	100%	3		
BOS (Shared Appreciation Mortgages) No. 1 plc	99.99% (100%)	3 #		
BOS (Shared Appreciation Mortgages) No. 2 plc	99.99% (100%)	3 #		
BOS (Shared Appreciation Mortgages) No. 3 plc	99.99% (100%)	3 #		
BOS (Shared Appreciation Mortgages) No. 4 plc	99.99% (100%)	3 #		
BOS (Shared Appreciation Mortgages) No. 5 plc	99.99% (100%)	3 #		
BOS (Shared Appreciation Mortgages) No. 6 plc	99.99% (100%)	3 #		
BOS (Southport) Holding LLC	100%	9		
BOS (USA) Fund Investments Inc.	100%	9 xiii		
BOS (USA) Inc.	100%	9		
BOS Edinburgh No 1 Ltd	100%	11		
BOS Mistral Ltd	100%	2		
BOSIC Inc.	100%	12		
BOSSAF Rail Ltd	100%	1		
Britannia Personal Lending Ltd	100%	3 i #		
British Linen Leasing (London) Ltd	100%	3		
British Linen Leasing Ltd	100%	4		
British Linen Shipping Ltd	100%	4		
Brooklyn Properties Ltd (in liquidation)	100%	16 i #		
	100%	ii		
Capital 1945 Ltd	100%	2		
Capital Bank Insurance Services Ltd	100%	3		
Capital Bank Leasing 1 Ltd	100%	2		
Capital Bank Leasing 2 Ltd	100%	2		
Capital Bank Leasing 3 Ltd	100%	2		
Capital Bank Leasing 4 Ltd	100%	2		
Capital Bank Leasing 5 Ltd	100%	2		
Capital Bank Leasing 6 Ltd	100%	2		
Capital Bank Leasing 7 Ltd	100%	2		
Capital Bank Leasing 8 Ltd	100%	11		
Capital Bank Leasing 9 Ltd	100%	2		
Capital Bank Leasing 10 Ltd	100%	2		
Capital Bank Leasing 11 Ltd	100%	2		
Capital Bank Leasing 12 Ltd	100%	4		
Capital Bank Property Investments (3) Ltd	100%	2		
Capital Bank Property Investments (6) Ltd				
(in liquidation)	100%	8		
Capital Bank Vehicle Management Ltd	100%	2		
Capital Leasing (Edinburgh) Ltd	100%	11		
Capital Leasing Ltd	100%	11		
Capital Personal Finance Ltd	100%	3		
Cartwright Finance Ltd	100%	2 viii		
	0.08%	vii #		
CBRail S.A.R.L.	100%	13		
CF Asset Finance Ltd	100%	2		
Chariot Finance Ltd	100%	1		
County Wide Property Investments Ltd				
(in liquidation)	100%	8		
Deva Lease 2 Ltd (in liquidation)	100%	8		
Deva Lease 3 Ltd (in liquidation)	100%	8		
First Retail Finance (Chester) Ltd	100%	3		
Flexify Ltd	100%	17		
Forthright Finance Ltd	100%	2		
Freeway Ltd	100%	2		
GFP Holdings LLC	100%	9		
Glossstrips Ltd	100%	11		
Godfrey Davis (Contract Hire) Ltd	100%	2		
Halifax Credit Card Ltd	100%	3 i		
	100%	ii		
	100%	vii		
Halifax Group Ltd	100%	3 ^		
Halifax Leasing (June) Ltd	100%	1		
Halifax Leasing (March No.2) Ltd	100%	1		
Halifax Leasing (September) Ltd	100%	1		
Halifax Ltd	99.99% (100%)	3 ^		
Halifax Loans Ltd	100%	3		
Halifax Mortgage Services (Holdings) Ltd	100%	3		
Halifax Mortgage Services Ltd	100%	3		
Halifax Nominees Ltd	100%	3		
Halifax Premises Ltd	100%	1		
Halifax Share Dealing Ltd	100%	3 ^		
Halifax Vehicle Leasing (1998) Ltd	100%	3		
HBOS Canada Inc.	100%	12		
HBOS Capital Funding (Jersey) Ltd	100%	6 ^		
HBOS Covered Bonds LLP	n/a	3 *		
HBOS Directors Ltd	100%	1		
HBOS Final Salary Trust Ltd	100%	4 ^		
HBOS Management (Jersey) Ltd	100%	6 ^		
HBOS Social Housing Covered Bonds LLP	n/a	2 *		
HBOS Treasury Services Ltd	100%	14		
HBOS UK Ltd	99.99% (100%)	4 ^		
HL Group (Holdings) Ltd (in liquidation)	100%	3		
Home Shopping Personal Finance Ltd	100%	3		
Horizon Capital 2000 Ltd	100%	11		
Horizon Capital Ltd	100%	11		
Horizon Hotel Investments Ltd (in liquidation)	100%	28		
Horizon Property Investments Ltd (in liquidation)	100%	28		
Horizon Resources Ltd	100%	11		
HSDL Nominees Ltd	100%	3		
IBOS Finance Ltd	100%	2		
IBOS Securities	n/a	+		
ICC Enterprise Partners Ltd (in liquidation)	100%	16		
ICC Equity Partners Ltd (in liquidation)	100%	16		
ICC ESOP Trustee Ltd	100%	17		
ICC Holdings Unlimited Company	99.09% (100%)	10		
ICC Software Partners Ltd (in liquidation)	100%	17		
IF Covered Bonds Limited Liability Partnership	n/a	3 *		
Intelligent Finance Financial Services Ltd	100%	3		
Intelligent Finance Software Ltd	100%	3		
IWEB (UK) Ltd (in liquidation)	100%	8		
Kanto Leasing Ltd	100%	1		
Katrine Leasing Ltd	100%	18		
Legacy Renewal Company Ltd	99.99% (100%)	4		
Lex Vehicle Leasing (Holdings) Ltd	100%	2 i		
	100%	ii		
	100%	x		
Lex Vehicle Leasing Ltd	100%	2		
Lex Vehicle Partners (1) Ltd	100%	2		
Lex Vehicle Partners (2) Ltd	100%	2		
Lex Vehicle Partners (3) Ltd	100%	2		
Lex Vehicle Partners (4) Ltd	100%	2		
Lex Vehicle Partners Ltd	100%	2		
Lloyds Bank (Fountainbridge 1) Ltd	100%	4		
Lloyds Bank (Fountainbridge 2) Ltd	100%	4		
London Uberior (L.A.S. Group) Nominees Ltd	n/a	4 *		
Lovat Funding Holdings Ltd (in liquidation)	100%	13		

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Meadowfield Investments Ltd	100%	4	Uberior Investments Ltd	99%	(100%)	11
Membership Services Finance Ltd	100%	3	Uberior ISAF CIP 2007 L.P	n/a		24 *
Moray Investments Ltd	100%	14	Uberior Nominees Ltd	n/a		4 *
Nevis Leasing Ltd	74%	18 #	Uberior Trading Ltd	99%	(100%)	11
NFU Mutual Finance Ltd	100%	2 i #	Uberior Trustees Ltd	n/a		4 *
	100%	vii	Uberior Ventures Australia Pty Ltd	100%		5
Nordic Leasing Ltd	100%	1	Uberior Ventures Ltd	100%		4
NWS 2	n/a	+	Vehicle Leasing (1) Ltd	100%		2
NWS Trust Ltd	100%	4	Vehicle Leasing (2) Ltd	100%		2
Ocean Leasing (July) Ltd	100%	1	Vehicle Leasing (3) Ltd	100%		2
Ocean Leasing (No 1) Ltd	100%	1	Vehicle Leasing (4) Ltd	100%		2
Ocean Leasing (No 2) Ltd	100%	1	Warwick Leasing Ltd	100%		2
Omnistone Ltd (in liquidation)	100%	16 i	West Craigs Ltd	100%		11
	100%	ii	Western Trust & Savings Holdings Ltd	100%		3
	98%	vii	Western Trust Holdings Ltd	100%		3
Oystercatcher LP	n/a	14*				
Pacific Leasing Ltd	100%	1				
Peony Eastern Leasing Ltd	100%	1				
Peony Leasing Ltd	100%	1				
Peony Western Leasing Ltd	100%	1				
Prestonfield Investments Ltd	100%	4				
Prestonfield P1 Ltd	100%	4				
Prestonfield P2 Ltd	100%	4				
Prestonfield P3 Ltd	100%	4				
Quion 6 BV	100%	21				
Saleslease Purchase Ltd	100%	11				
Scotland International Finance B.V.	100%	15				
Scotland International Finance No. 2 B.V.						
(in liquidation)	100%	15				
Scotmar Commercial Equipment Finance Ltd	100%	2 i #				
Seabreeze Leasing Ltd	100%	1				
Seadance Leasing Ltd (in liquidation)	100%	8				
Seaforth Maritime (Highlander) Ltd	100%	11				
Seaforth Maritime (Jarl) Ltd	100%	11				
Seaspirit Leasing Ltd	100%	1				
Seaspray Leasing Ltd	100%	1				
Share Dealing Nominees Ltd	100%	3				
Shibden Dale Ltd (in liquidation)	100%	8				
Standard Property Investment (1987) Ltd	100%	11 i				
	100%	ii				
Standard Property Investment Ltd	60.34%	22 #				
Sussex County Homes Ltd	100%	3				
Tantallon Investments, Inc.	100%	20				
The British Linen Company Ltd	99.98%	(100%) 5				
The Mortgage Business plc	99.99%	(100%) 3				
Thistle Leasing	n/a	+				
Tower Hill Property Investments (7) Ltd	90%	2 #				
Tower Hill Property Investments (10) Ltd	90%	2 #				
Tranquility Leasing Ltd	100%	1				
Uberior (Moorfield) Limited	100%	11				
Uberior Canada LP Ltd	100%	23				
Uberior Co-Investments Ltd	100%	11				
Uberior ENA Ltd	100%	11				
Uberior Equity Ltd	100%	11				
Uberior Europe Ltd	100%	4				
Uberior Fund Investments Ltd	100%	11				
Uberior Infrastructure Investments Ltd	100%	11				
Uberior Infrastructure Investments (No.2) Ltd	100%	1				

Subsidiary undertakings (continued)

The Group has determined that it has the power to exercise control over the following entities without having the majority of the voting rights of the undertakings. Unless otherwise stated, the undertakings do not have share capital or the Group does not hold any shares.

Name of undertaking	Notes
Addison Social Housing Holdings Ltd	25
Candide Financing 2006 BV	26
Candide Financing 2007 NHG BV	26
Candide Financing 2008-1 BV	26
Candide Financing 2008-2 BV	26
Candide Financing 2011-1 BV	26
Candide Financing 2012-1 BV	26
Craig Financing Holdings Ltd	19
Deva Financing Holdings Ltd	19
Deva Financing plc	19
Edgbaston RMBS 2010-1 plc	19
Edgbaston RMBS Holdings Ltd	19
Headingley RMBS 2011-1 Holdings Ltd	19
Leicester Securities 2014 Ltd	27
Lingfield 2014 I Holdings Ltd	19
Lingfield 2014 I plc	19
Penarth Asset Securitisation Holdings Ltd	19
Penarth Funding 1 Ltd	25
Penarth Funding 2 Ltd	25
Penarth Master Issuer plc	19
Penarth Receivables Trustee Ltd	25
Permanent Funding (No. 1) Ltd	19
Permanent Funding (No. 2) Ltd	19
Permanent Holdings Ltd	19
Permanent Master Issuer plc	19
Permanent Mortgages Trustee Ltd	19
Permanent PECOH Holdings Ltd	19
Permanent PECOH Ltd	19
Trinity Financing Holdings Ltd	19
Trinity Financing plc	19

Associated undertakings

The Group has a participating interest in the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)	Registered office address (UK unless stated otherwise)	Notes
Addison Social Housing Holdings Ltd	20%	35 Great St Helen's, London, EC3A 6AP	
Agora Shopping Centres Ltd (in receivership)	50%	Hill House, 1 Little New Street, London, EC4A 3TR	ii
Aspire Oil Services Ltd	28.4%	Union Plaza, 6th Floor, 1 Union Wynd, Aberdeen, AB10 1DQ	
Australand Apartments No.6 Pty Ltd	50%	Level 3, 1 Chomebush Bay Drive, Rhodes, NSW 2138, Australia	
Australand Residential Investments Pty Ltd	50%	Level 3, 1 Chomebush Bay Drive, Rhodes, NSW 2138, Australia	
Australand Residential Trust	50%	Level 3, 1 Chomebush Bay Drive, Rhodes, NSW 2138, Australia	
AVJBOS Nominees Proprietary Ltd	50%	Ground Floor, 1 Lakeside Drive, Burwood East, VIC 3151, Australia	
Bergamot Ventures Ltd	45%	6th Floor 25 Farringdon Street, London, EC4A 4AB	ii
BoS Mezzanine Partners Fund LP	n/a	7 Melville Crescent, Edinburgh, EH3 7JA	*
Business Growth Fund plc	24.3%	13-15 York Buildings, London, England, WC2N 6JU	
Cary Towne Parke Holdings LLC	98%	Jeffrey Cohen, 1066 Woodward Avenue, Detroit, MI 48226, United States	
Cary Towne Parke LLC	100%	National Registered Agents Inc., 150 Fayetteville Street, Raleigh, NC 2782, United States	
City & General Securities Ltd	100%	10 Upper Berkeley Street, London, W1H 7PE	ii
Connery Ltd	20%	44 Esplanade St Helier Jersey JE4 9WG	
Continental Shelf 225 Ltd (in liquidation)	100%	4 Mount Ephraim Road, Tunbridge Wells, Kent, TN1 1EE	i
Continental Shelf 291 Ltd (in liquidation)	100%	4 Mount Ephraim Road, Tunbridge Wells, Kent, TN1 1EE	i
Craig Finance Ltd	20%	35 Great St. Helen's, London, EC3A 6AP	
D.U.K.E Real Estate Ltd	100%	1st Floor, Exchange Place, 3 Sample Street, Edinburgh, EH3 8BL	
Europa Property Company (Northern) Ltd	100%	Europa House, 20 Esplanade, Scarborough, North Yorkshire, YO11 2AQ	vii

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European Property Fund (Holdings) Ltd SARL	24.9%	1 Allee Scheffer, Luxembourg, L-25250, Luxembourg	ii
Fern Bay Seaside Village Ltd (in liquidation)	34.48%	Septimus Roe Square, Level 8, 256 Adelaide Terrace, Perth, WA 6000, Australia	
FHR European Ventures LLP	n/a	CMS Cameron McKenna LLP, 78 Cannon Street, London, EC4N 6AF	*
Golfview Apartment Holdings LLC	43.758%	Jeffrey Cohen, 1066 Woodward Avenue, Detroit, MI 48226, United States	
Golfview Apartments LLC	88%	300 South Orange Avenue, Suite 100, Orlando, FL 32801, United States	
HBOS Capital Funding LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Capital Funding No. 1 LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Capital Funding No. 3 LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Capital Funding No. 4 LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Euro Finance (Jersey) LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Sterling Finance (Jersey) LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
Kenmore Capital 2 Ltd (in liquidation)	100%	Grant Thornton UK LLP, 95 Bothwell Street, Glasgow, G2 7JZ	ii
Kenmore Capital 3 Ltd (in receivership)	100%	Grant Thornton UK LLP, 95 Bothwell Street, Glasgow, G2 7JZ	ii
Kenmore Capital Ltd (in liquidation)	100%	Grant Thornton UK LLP, 95 Bothwell Street, Glasgow, G2 7JZ	ii
Lighthouse Healthcare Group Ltd	71.96%	2nd Floor Bezant House, Bradgate Park View, Chellaston, Derbyshire, DE73 5UH	v
	59.71%		i
	77.07%		ii
Lothian Fifty (150) Ltd (in liquidation)	100%	55 Baker Street, London, W1U 7EU	i
Morston Assets Ltd (in administration)	20%	KPMG LLP, Arlington Business Park, Theale, Reading, Berkshire, RG7 4SD	
Motability Operations Group plc	20%	City Gate House, 22 Southwark Bridge Road, London, SE1 9HB	iv
Northern Edge Ltd	39.4%	The Beacon, 176 St. Vincent Street, Glasgow, G2 5SG	ii
PIHL Equity Administration Ltd	100%	Cavendish House, 18 Cavendish Square, London, W1G 0PJ	ii
Prestbury 1 Limited Partnership	n/a	Cavendish House, 18 Cavendish Square, London, W1G 0PJ	*
Prestbury Hotel Holdings Ltd (in liquidation)	100%	15 Canada Square, London, E14 5GL	vii
Prestbury Wentworth Holdings Ltd (in liquidation)	100%	KPMG LLP Arlington Business Park, Theale, Reading, RG7 4SD	vii
Sapphire Retail Fund Ltd (in liquidation)	50%	Grant Thornton UK LLP, 30 Finsbury Square, London, EC2P 2YU	ii
Southport Green Acquisition LLC	50%	1095 Avenue of the Americas, New York, NY 10036, United States	
Stewart Milne (Glasgow) Ltd	100%	Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE	i
Stewart Milne (West) Ltd	100%	Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE	i
Tantallon Acquisition LLC	100%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Tantallon Austin Hotel LLC	100%	National Registered Agents Inc., 160 Greentree Drive, Suite 101, Dover, DE19904, United States	
Tantallon Austin LLC	100%	National Registered Agents Inc., 160 Greentree Drive, Suite 101, Dover, DE19904, United States	
Tantallon LLC	50%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
The Scottish Agricultural Securities Corporation plc (in liquidation)	33.33%	Titanium, 1 Kings Inch Place, Renfrew, PA4 8WF	
Thread Real Estate Cary Towne Park LLC	50%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Thread Real Estate Golfview LLC	50%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Valad Canadian Partners LP	n/a	44 Chipman Hill, Suite 100, St. John, NB E2L 2A9, Canada	*
Whitefleet Ltd (in liquidation)	100%	1 More London Place, London, SE1 2AF	i &
Zog Brownfield Ventures Ltd (in administration)	50%	1 More London Place, London, SE1 2AF	

* The undertaking does not have share capital

+ The undertaking does not have a registered office

In relation to Subsidiary Undertakings, an undertaking external to the Group holds shares

^ Shares held directly by HBOS plc

& The Group holds voting rights of between 20% and 49.9%

(i) A Ordinary shares

(iii) B Ordinary shares

(iii) Deferred shares

(iv) Preference shares

(v) Preferred ordinary shares

(vi) Non-voting shares

(vii) C Ordinary shares

(viii) N Ordinary shares

(ix) Callable preference shares

(x) Redeemable preference shares

(xi) Ordinary limited voting shares

(xii) Redeemable ordinary shares

(xiii) Common stock

Registered office addresses

(1) 25 Gresham Street, London, EC2V 7HN

(2) Charterhall House, Charterhall Drive, Chester, CH88 3AN

(3) Trinity Road, Halifax, HX1 2RG

(4) The Mound, Edinburgh, EH1 1YZ

(5) Minter Ellison, Governor Macquarie Tower, Level 40, 1 Farrer Place, Sydney, NSW 2000, Australia

(6) Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT

(7) 26th Floor, Oxford House, Taikoo Place, Quarry Bay, Hong Kong

(8) 1 More London Place, London, SE1 2AF

(9) 1095 Avenue of the Americas, 34th Floor, New York, NY 10036, United States

(10) Rineanna House, Shannon Free Zone, Co. Clare, Ireland

(11) Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE

(12) Cox and Palmer, Suite 400, 371 Queen Street, Phoenix Square, Fredericton, NB E3B 4Y9, Canada

(13) 4 Rue Alphonse Weicker, L-2721, Luxembourg

(14) 33 Old Broad Street, London, EC2N 1HZ

(15) Prins Bernhardplein 200, 1097 JB, Amsterdam, Netherlands

(16) McStay Luby, Dargan House, 21-23 Fenian Street, Dublin 2, Ireland

(17) 124-127 St. Stephen's Green, Dublin 2, Ireland

(18) 47 Esplanade, St. Helier, Jersey, JE1 0BD

(19) 35 Great St. Helen's, London, EC3A 6AP

(20) Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States

(21) Lichtenauerlann 170, 3062ME, Rotterdam, Netherlands

(22) Caledonian Exchange, 19A Canning Street, Edinburgh, EH3 8HE

(23) 44 Chipman Hill, Suite 100, St. John, NB E2L 2A9, Canada

(24) 155 Bishopsgate, London, EC2M 3YB

(25) 44 Esplanade, St. Helier, Jersey, JE4 9WG

(26) Fred. Roeskestraat 123, 1076 EE, Amsterdam, Netherlands

(27) 1st Floor, 1-2 Victoria Buildings, Haddington Road, Dublin 4, Ireland

(28) 10 George Street, Edinburgh, EH2 2OZ