Taxation

The rate of tax is influenced by the geographic and business mix of profits. In the absence of special factors, Lloyds TSB Group does not expect the tax rate to vary significantly from the average UK corporation tax rate.

	2004	2003	2002
	£m	£m	£m
UK corporation tax:			
– Current tax on profits for the year	**841**	1,079	786
– Adjustments in respect of prior years	**(38)**	(72)	12
	803	1,007	798
Double taxation relief	**(58)**	(223)	(129)
	745	784	669
Foreign tax:			
– Current tax on profits for the year	**119**	144	216
– Adjustments in respect of prior years	**(5)**	(15)	(15)
	114	129	201
Current tax charge	**859**	913	870
Deferred tax	**146**	119	(106)
Associated undertakings and joint ventures	**(1)**	(7)	2
Total charge	**1,004**	1,025	766

2004 compared with 2003

The effective rate of tax in 2004 was 28.7 per cent, compared to an effective rate of tax in 2003 of 23.6 per cent and the corporation tax rate in 2004 of 30 per cent. The higher effective rate of tax in 2004 is primarily because the effective rate in 2003 benefited from the fact that the gain on disposal of The National Bank of New Zealand was exempt from taxation; this was only partly offset by the benefit, in 2004, of lower effective rates of tax in the Lloyds TSB Group's life and pensions businesses, due to an improved performance in the investment portfolios. See note 9 to the financial statements.

2003 compared with 2002

The effective rate of tax in 2003 was 23.6 per cent, compared to an effective rate of tax of 29.3 per cent in 2002 and the corporation tax rate in 2003 of 30 per cent. The lower effective rate of tax in 2003 was primarily due to the gain on disposal of The National Bank of New Zealand, which was exempt from taxation, and a reduction in the non-allowable element of foreign taxes paid creditable against the UK corporation tax charge. This was partly offset by the withdrawal of tax relief on payments to the Lloyds TSB Group qualifying share ownership trust ('QUEST') to satisfy Save As You Earn options.

Economic profit

In pursuit of the Group's aim to maximise shareholder value over time, management has for a number of years used a system of value based management as a framework to identify and measure value creation. Management uses economic profit, a non-GAAP measure, as a measure of performance, and believes that it provides important information for investors, because it captures both growth in investment and return; profit before tax is the comparable GAAP measure used by management. Lloyds TSB Group defines economic profit as the earnings on the equity invested in the business less a notional charge for the cost of the equity invested in that business.

Lloyds TSB Group believes that economic profit instils financial discipline in determining investment decisions throughout Lloyds TSB Group and that it enables Lloyds TSB Group to evaluate alternative strategies objectively, with a clear understanding of the value created by each strategy, and then to select the strategy which creates the greatest value. Awards to senior executives under Lloyds TSB Group's annual bonus arrangements are partly determined by the achievement of economic profit targets.

Management changes its estimates of the cost of equity only to reflect significant changes in long-term interest rates and other external market factors which are considered sustainable. The principal factor in estimating the cost of equity is sustainable long-term interest rates. If long-term interest rates increase, management will consider raising its estimate of the cost of equity; if long-term interest rates fall, management will consider reducing its estimate of the cost of equity. The principal other external market factors considered are equity risk premium and Lloyds TSB Group's share price volatility relative to the UK stock market as a whole. Any change to the estimated cost of equity will be disclosed. For the last three years, management has used a cost of equity of 9 per cent to reflect the shareholders' minimum required rate of return on equity invested.

The table below summarises Lloyds TSB Group’s calculation of economic profit for the years indicated.

	2004	2003	2002
	£m	£m	£m
Average shareholders’ equity	**9,956**	8,460	10,672
Profit attributable to shareholders	**2,421**	3,254	1,790
Less: notional charge	**(896)**	(761)	(960)
Economic profit	**1,525**	2,493	830

The notional charge has been calculated by multiplying average shareholders’ equity by the cost of equity.

2004 compared with 2003

Economic profit decreased to £1,525 million in 2004 compared to £2,493 million in 2003. Profit attributable to shareholders decreased by £833 million, or 26 per cent, to £2,421 million principally due to the significant profits on disposal of businesses in 2003 of £865 million, on which no tax charge arose; the notional charge on average equity was £135 million higher, as a result of an 18 per cent increase in average equity to £9,956 million compared to £8,460 million in 2003.

2003 compared with 2002

Economic profit increased by £1,663 million from £830 million in 2002 to £2,493 million in 2003. Profit attributable to shareholders increased by £1,464 million, or 82 per cent, to £3,254 million; the notional charge on average equity was £199 million lower, as a result of a 21 per cent reduction in average equity to £8,460 million from £10,672 million in 2002.

Line of business information

Summary

In order to provide a clearer representation of the underlying performance, the results of the Insurance and Investments segment include investment earnings calculated using longer-term rates of return and annual management charges based on unsmoothed fund values. Management separately analyse the difference between these normalised earnings and the actual return (‘the investment variance’) together with the impact of changes in the economic assumptions used in the embedded value calculation. The results of the businesses are set out below:

	2004	2003	2002
	£m	£m	£m
UK Retail Banking	**1,651**	1,471	1,548
Insurance and Investments	**773**	565	638
Wholesale and International Banking – continuing operations	**1,272**	1,038	1,005
Central group items	**(333)**	(12)	36
	3,363	3,062	3,227
Changes in economic assumptions	**(2)**	(22)	55
Investment variance	**147**	125	(943)
Loss on sale of businesses in 2004	**(15)**	–	–
Discontinued operations in 2003 and 2002	**–**	1,183	279
Profit before tax	**3,493**	4,348	2,618

Comparative figures for 2003 and 2002 have been restated to reflect changes in the Lloyds TSB Group’s segmental analysis following the introduction, in 2004, of the management of the Lloyds TSB Group’s distribution channels as profit centres and other changes in internal transfer pricing arrangements. The loss on sale of businesses in 2004 and discontinued operations in 2003 and 2002 relate to the Wholesale and International Banking segment. The discontinued operations in 2003 and 2002 were the Lloyds TSB Group’s operations in New Zealand, Brazil and France, sold in 2003.

UK Retail Banking

	2004 **£m**	2003† £m	2002† £m
Net interest income	**3,198**	3,137	2,890
Other income	**1,639**	1,533	1,567
Total income	**4,837**	4,670	4,457
Operating expenses	**(2,513)**	(2,583)	(2,402)
Trading surplus	**2,324**	2,087	2,055
Provisions for bad and doubtful debts	**(673)**	(594)	(496)
Share of results of joint ventures	**–**	(22)	(11)
Profit before tax	**1,651**	1,471	1,548
Profit before tax, before provisions for customer redress	**1,751**	1,671	1,548
Cost:income ratio	**52.0%**	55.3%	53.9%
Total assets (year-end)	**£101,615m**	£90,541m	£79,629m
Total risk-weighted assets (year-end)	**£60,502m**	£54,119m	£48,313m

† Restated, as explained on page 26.

2004 compared with 2003

Profit before tax from UK Retail Banking increased by £180 million, or 12 per cent, to £1,651 million, compared to £1,471 million in 2003. However, comparisons of performance are distorted by the level of the charge made in respect of provisions for customer redress, which was £100 million in 2004 compared to £200 million in 2003; excluding these provisions for customer redress, profit before tax in UK Retail Banking increased by £80 million, or 5 per cent to £1,751 million from £1,671 million in 2003.

Total income rose by £167 million, or 4 per cent, to £4,837 million compared to £4,670 million in 2003. Net interest income was £61 million, or 2 per cent, higher at £3,198 million, compared to £3,137 million in 2003. Average interest-earning assets were £10,875 million higher than in 2003. There was strong growth in mortgage lending during the year; gross new mortgage lending was £26,251 million, compared to £24,151 million in 2003, representing a market share of 9.0 per cent. Net new mortgage lending of £9,315 million was 12 per cent higher than the £8,283 million achieved in 2003 and represented a market share of 9.2 per cent. Mortgage balances outstanding increased by 13 per cent to £80,065 million. There was also good growth in personal loans and overdrafts, where average balances were £1,141 million higher and in card services, where average balances were £1,424 million higher, in part reflecting the acquisition of the Goldfish business at the end of September 2003. This volume growth generated an additional £387 million of net interest income.

The net interest margin, however, fell by 41 basis points, reducing net interest income by £326 million, reflecting in part continuing competitive pressures in mortgages and in other retail lending products such as overdrafts and personal loans.

Other income was £106 million, or 7 per cent, higher at £1,639 million compared to £1,533 million in 2003. This increase reflects the acquisition of the Goldfish business in 2003, as a result of which the 2004 figures include a full year's fee income compared to only three months in 2003. This lead to a significant increase in card fee income, up £81 million overall, only partly offset by a related increase in card fees payable. Card fee income also grew as a result of organic growth in the Lloyds TSB Group's existing business and a review of charging structures. Current account fees within UK Retail Banking were £13 million higher as a result of continued growth in added value account fees and an increased level of returned cheque fees. There were also increased management fees with the UK Wealth Management business, as a result of higher asset values.

Operating expenses were £70 million, or 3 per cent, lower at £2,513 million compared to £2,583 million in 2003. However, excluding the effect of the provisions for customer redress, operating expenses were £30 million, or 1 per cent, higher at £2,413 million compared to £2,383 million in 2003. The full year impact of the Goldfish acquisition and the effect of annual pay awards was partly offset by a lower level of bonuses in some areas and staff reductions, particularly in the distribution network; staff numbers at 31 December 2004 were 43,732, down 563 from 44,295 at the end of 2003. The cost:income ratio improved to 52.0 per cent from 55.3 per cent in 2003. Excluding the charges in respect of provisions for customer redress of £100 million in 2004 and £200 million in 2003, the cost:income ratio improved to 49.9 per cent in 2004 compared to 51.0 per cent in 2003.

Provisions for bad and doubtful debts were £79 million, or 13 per cent, higher at £673 million compared to £594 million in 2003. Of this increase, £37 million is attributable to the full year impact of the Goldfish business and the remainder reflects organic growth in the lending portfolios during 2004. Personal loan balances increased by £1,126 million, or 12 per cent, to £10,745 million over 2004 and credit card balances increased by £792 million, or 12 per cent, to £7,519 million. The provisions charge as a percentage of average lending for personal loans and overdrafts fell to 4.20 per cent, from 4.25 per cent in 2003, while the charge in the credit card portfolio increased to 3.42 per cent, from 3.19 per cent in 2003. In the mortgages business, there was a net provision release of £42 million, reflecting the continuing low level of losses in a climate of rising house prices and historically low interest rates. The provisions charge as a percentage of average lending was 0.71 per cent, compared to 0.72 per cent in 2003, and the overall arrears position remained satisfactory.

2003 compared with 2002

Profit before tax from UK Retail Banking decreased by £77 million, or 5 per cent, to £1,471 million, compared to £1,548 million in 2002. However, the results in 2003 were adversely affected by a £200 million provision for remediation payments to customers in respect of past sales of mortgage endowment and long-term savings products, principally the Extra Income & Growth Plan; adjusting for this provision there was a £123 million or 8 per cent growth in profit.

Total income increased by £213 million, or 5 per cent, to £4,670 million. Net interest income increased by £247 million, or 9 per cent, to £3,137 million as continued growth in lending and deposit balances added £379 million to net interest income partly offset by a reduction of £132 million caused by a 19 basis point reduction in the net interest margin. There was good organic growth in the personal loan and credit card businesses with outstanding balances increasing by 9 per cent and 18 per cent respectively over the year; after taking account of the impact of the acquisition of the Goldfish Bank portfolios, outstanding personal loan balances had increased by 10 per cent and credit card balances by 36 per cent by the end of December 2003. Over the twelve months to 31 December 2003, mortgage balances outstanding increased by 13 per cent to £70,750 million as net new lending increased to £8,283 million from £5,889 million; this represented an improved market share of 8.2 per cent although it remained below the Lloyds TSB Group’s market share of outstanding mortgages.

The net interest margin was 19 basis points lower. There was margin contraction in the mortgages business as competitive pressures caused a move to discounted and finer margin products; the margin on retail savings products also fell as the full effect of interest rate falls was not passed on to customers and the benefit of low interest and interest-free current accounts was reduced. This was partly offset by an improved margin on personal loans, which benefited from lower funding costs.

Other income decreased by £34 million to £1,533 million. Fees earned from current account activity grew by £44 million reflecting increased volumes of added value accounts and higher monthly charges; returned cheque fees also increased as the number of returned items rose. There was also improved income from credit and debit card transactions, which increased by £46 million, mainly as a result of a growth in interchange income, higher overseas use commissions and other fees. These increases, however, were more than offset by a reduction in distribution commissions received for the sale of insurance products through the branch network and higher fees payable in respect of the credit card business, mainly reflecting volume growth and the cost of customer incentives, and increased package costs incurred on the added value account range as volumes have risen. A growth in fee income in the mortgages business, as lending volumes have grown and charges increased, has been offset by the higher cost of customer incentives.

Operating expenses were £181 million, or 8 per cent higher, at £2,583 million compared to £2,402 million in 2002 as a result of the £200 million provision for customer redress; if this is excluded operating expenses fell by £19 million. There was an increase in salary and pension costs, largely reflecting the effects of the annual pay review and falling interest rates on the cost of providing post-retirement benefits, and the increased cost of agency staff and other contractors which have been offset to an extent by lower severance and related costs following the completion of a number of major restructuring initiatives. Advertising expenditure also increased particularly in the credit card and mortgage businesses and there was wider use of TV advertising; however there was a reduction in the level of operational losses and lower clearings costs. The cost:income ratio deteriorated to 55.3 per cent compared to 53.9 per cent in 2002; however, if the £200 million provision for customer redress is excluded from costs in 2003, the cost:income ratio improved to 51.0 per cent.

Bad debt provisions increased by £98 million to £594 million in 2003 compared to £496 million in 2002 as a result of an increase in the provisions required against the personal lending and credit card portfolios mainly reflecting volume growth during the year but also some deterioration in the arrears levels within the personal loan portfolio and an increase in fraud related losses. There was a net release of £18 million from the provisions held against the mortgage portfolio in 2003 compared to a net release of £1 million in 2002, as the arrears position has improved and the value of the underlying security increased. The provisions charge as a percentage of average lending for personal loans and overdrafts increased to 4.25 per cent in 2003 from 3.73 per cent in 2002, while the charge in the credit card portfolio decreased to 3.19 per cent in 2003 from 3.52 per cent the previous year.

The Lloyds TSB Group’s share of the results of its joint venture operations in 2003 was a loss of £22 million compared to £11 million in 2002. Following the purchase by the Lloyds TSB Group of the personal loan and credit card portfolios of Goldfish Bank, the venture began to wind down its remaining business resulting in increased losses from asset write-downs and closure provisions.

Insurance and Investments

Lloyds TSB Group’s insurance and investments activities comprise the life, pensions and unit trust businesses of Scottish Widows and Abbey Life, general insurance underwriting and broking, and Scottish Widows Investment Partnership.

	2004 **£m**	2003† £m	2002† £m
Net interest income	**99**	81	74
Other income	**1,170**	981	1,084
Total income	**1,269**	1,062	1,158
Operating expenses	**(272)**	(261)	(291)
Trading surplus	**997**	801	867
General insurance claims	**(224)**	(236)	(229)
Operating profit	**773**	565	638
Changes in economic assumptions	**(2)**	(22)	55
Investment variance	**147**	125	(943)
Profit (loss) before tax	**918**	668	(250)

† Restated, as explained on page 26.

2004 compared to 2003

The operating profit from Insurance and Investments, calculated as explained under ‘Operating and financial review and prospects – Line of business information – Summary’ increased by £208 million, or 37 per cent, to £773 million in 2004 compared to £565 million in 2003.

Total income was £207 million, or 19 per cent, higher at £1,269 million compared to £1,062 million in 2003. Net interest income of £99 million was £18 million, or 22 per cent, higher than in 2003 reflecting increased cash balances held within the general insurance businesses.

Other income was £189 million, or 19 per cent, higher at £1,170 million in 2004 compared to £981 million in 2003. Income from long-term assurance business, excluding the effects of changes in economic assumptions and the investment variance, was £165 million higher as a result of improved profitability from new and existing business and a reduced charge in respect of provisions for customer redress (£12 million in 2004 compared to £100 million in 2003). General insurance underwriting premiums were £19 million higher as reduced premiums on the health insurance book, which is being run down, were more than offset by increased income from home contents and asset finance creditor insurance. Reduced levels of retrospective and motor insurance broking commissions lead to a decrease of £18 million in general insurance broking commissions, but improved market conditions lead to increases in asset management income.

Operating expenses were £11 million, or 4 per cent, higher at £272 million in 2004 compared to £261 million in 2003; this reflected higher staff costs, largely as a result of annual pay reviews, and some increase in strategic consultancy spend.

General insurance claims of £224 million in 2004 were down £12 million, or 5 per cent, from £236 million in 2003, reflecting favourable weather conditions.

2003 compared to 2002

The operating profit from Insurance and Investments, calculated as explained under ‘Operating and financial review and prospects – Line of business information – Summary’, fell by £73 million, or 11 per cent, to £565 million from £638 million in 2002.

Total income was £96 million, or 8 per cent lower, at £1,062 million as a £103 million fall in other income more than offset a modest improvement in net interest income of £7 million. Other income was £981 million compared to £1,084 million in 2002. Income from long-term assurance business, excluding the effects of changes in economic assumptions and the investment variance, was £86 million lower. Income from existing business was lower as the benefit from experience variances and actuarial assumption changes reduced by £168 million, reflecting updated assumptions in respect of staff costs to support existing business and benefits recognised in 2002 from changes in the assumed shareholder tax rate and from the valuation of unmodelled products which have not been repeated; the expected return increased by £10 million. There was also a reduction of £61 million in normalised investment earnings reflecting lower market rates of return. This has been partly offset by a £105 million reduction in provisions for customer redress, see ‘Operating and financial review and prospects – Risk management – Customer treatment risk – Customer remediation payments’, and by the £41 million increase in new business profitability.

Insurance broking income fell by £43 million reflecting lower levels of creditor insurance and an increased allowance for the clawback of commissions by the insurance underwriters due to the early settlement of loans. There was also a reduction in income from unit trust and asset management activities as a result of lower average fund values and the continued weakness of the long-term savings market. This has been partly offset by a £49 million increase in general insurance premiums as income from the sale of home contents insurance has improved, helped by the buoyant housing market.

Operating expenses decreased by £30 million, or 10 per cent, to £261 million. There was a £42 million reduction in the costs related to the restructuring of the Scottish Widows business and this has more than offset the effect of inflationary increases in other costs.

General insurance claims increased by £7 million to £236 million, as the effect of the increase in the size of the portfolio was largely offset by a reduction in claims caused by the generally mild weather conditions.

Area of business

The operating profit of the life, pensions and unit trust businesses is analysed in the following table. The basis of this analysis is as follows:

The life and pensions results are split into five elements:

- New business income: this represents the value recognised at the end of each financial year from the new business written during that year after taking into account the cost of establishing technical provisions and reserves. This is shown before the significant costs of acquiring that new business, which are shown separately as ‘Distribution costs’.
- Distribution costs: the costs of acquiring the new business generated in the year. These comprise the cost of selling products through Lloyds TSB Bank’s branch network; the commissions paid to independent financial advisers (“IFAs”) and related costs of sales through this channel; and the costs of other direct sales channels.
- Existing business: this comprises the following elements:

– the expected return arising from the unwinding of the discount applied to the expected cash flows at the beginning of a year;

– experience variances caused by differences between the actual experience during the year and the expected experience;

– the effects of changes in assumptions, other than economic assumptions, and other items; and

– provisions for customer redress.

- Development costs: these costs represent the investment made during the year in Sandler products and depolarisation developments, and the development of e-commerce relationships with IFAs.
- Investment earnings: this represents the expected investment return on both the net tangible assets and the value of the shareholder’s interest in the long-term business account, based upon the economic assumptions made at the beginning of the year.

Unit trust income is shown before the acquisition costs of new business which are separately disclosed.

	2004 **£m**	2003† £m	2002† £m
Life and pensions new business income	**419**	396	313
Life and pensions distribution costs	**(231)**	(241)	(199)
New business contribution	**188**	155	114
Existing business:			
Expected return	**300**	283	273
Experience variances	**(41)**	(16)	(1)
Assumption changes and other items	**(39)**	(75)	78
	220	192	350
Provisions for customer redress	**(12)**	(100)	(205)
Development costs	**(11)**	(13)	–
Investment earnings	**167**	153	214
Operating profit (life and pensions)	**552**	387	473
Unit trusts	**75**	62	92
Unit trust distribution costs	**(22)**	(38)	(44)
Profit before tax (unit trusts)	**53**	24	48
Operating profit (life, pensions and unit trusts)	**605**	411	521
General insurance	**160**	153	117
Scottish Widows Investment Partnership	**8**	1	–
Operating profit	**773**	565	638
Changes in economic assumptions	**(2)**	(22)	55
Investment variance	**147**	125	(943)
Profit (loss) before tax	**918**	668	(250)
New business margin (life and pensions)	**28.6%**	25.8%	19.2%

† Restated, as explained on page 26.

The table below shows the level of new business premium income for the life and pensions business and unit trust sales. Management monitor these figures because they provide an indication of both the performance and the profitability of the business.

	2004 **£m**	2003 £m	2002 £m
New business premium income and unit trust sales			
Regular premiums	**342.6**	337.9	286.3
Single premiums	**3,141.0**	2,638.3	3,089.0
Unit trusts:			
– Regular premiums	**32.6**	41.0	71.5
– Single premiums	**538.4**	907.3	1,009.5
Total unit trusts	**571.0**	948.3	1,081.0

Weighted sales is a UK insurance industry standard which measures the new business volumes; the weighting is made towards regular premium policies to reflect the long-term nature of these contracts. There are four main distribution channels for the sale of Lloyds TSB Group’s life, pension and unit trust products and the table below shows the relative importance of each.

	2004 **£m**	2003 £m	2002 £m
Weighted sales (regular + 1/10 single):			
Life and pensions	**656.7**	601.7	595.2
Unit trusts	**86.4**	131.7	172.4
Life, pensions and unit trusts	**743.1**	733.4	767.6
Weighted sales by distribution channel:			
Branch network	**238.9**	278.8	350.6
Independent financial advisers	**431.6**	391.6	335.4
Direct	**72.2**	61.6	67.9
Other, including International	**0.4**	1.4	13.7
Life, pensions and unit trusts	**743.1**	733.4	767.6

Life, pensions and unit trusts

2004 compared to 2003

Operating profit from life, pensions and unit trusts, calculated as explained under ‘Operating and financial review and prospects – Line of business information – Summary’ increased by £194 million, or 47 per cent, to £605 million in 2004 compared to £411 million in 2003; much of this improvement reflected the lower charge in respect of provisions for customer redress of £12 million in 2004, compared to £100 million in 2003. Excluding the charge in respect of provisions for customer redress, operating profit from life, pensions and unit trusts increased by £106 million or 21 per cent to £617 million in 2004 compared to £511 million in 2003.

Within the life and pensions businesses, new business contribution increased by £33 million or 21 per cent to £188 million. New business income was £23 million or 6 per cent higher reflecting a 9 per cent growth in the weighted sales of life and pensions products, driven in particular by higher sales of investment products such as the Flexible Option Bond and the Combination Bond. Distribution costs at £231 million were £10 million lower than in 2003, largely as a result of a change in business mix together with the non-repetition of short-term, fine margin, asset finance related business in the last quarter of 2003. The new business margin, defined as new business contribution divided by weighted sales, was 28.6 per cent compared to 25.8 per cent in 2003.

Regular premium sales of £342.6 million were 1 per cent higher than in 2003 and represented 52 per cent of total weighted sales from life and pensions business, compared to 56 per cent in 2003. Sales of regular premium pensions products were £25.3 million higher, with growth in sales through independent financial advisers and direct channels, as a result of focussed investment in this business and the promotion of specially targeted products more than offsetting a fall in sales through the branch network. Regular life product sales, however, were £18.9 million lower, largely as a result of competitor pricing issues and the impact of some slow down in activity in the mortgage market.

Sales of single premium life and pensions products were £502.7 million, or 19 per cent, higher at £3,141.0 million compared to £2,638.3 million in 2003. There was substantial growth in single premium life sales, reflecting the success of the Combination Bond and the Flexible Option Bond, which have been relaunched and made the subject of increased marketing focus. Sales of annuity products were down due to the decision to withdraw from the with-profits annuity market in 2004, only partly offset by increased sales of the Income Drawdown product. Single premium pension sales were 6 per cent higher, as a result of strong sales of group pension products through the independent financial advisers.

The expected return from existing business was £17 million, or 6 per cent, higher at £300 million compared to £283 million in 2003; the increase reflects the benefit of new business sales by Scottish Widows in 2003 and the effect of the increase in the embedded value discount rate. The impact of experience variances and actuarial assumption changes was a charge of £80 million, £11 million better than the charge of £91 million in 2003; adverse lapse and expense assumption experience being more than offset by the non-repetition of the impact in 2003 of the capitalisation of pension contributions. The charge in respect of provisions for customer redress was significantly lower at £12 million in 2004, compared to £100 million in 2003.

Development costs were £11 million in 2004, compared to £13 million in 2003, and investment earnings were £14 million, or 9 per cent, higher at £167 million in 2004 compared to £153 million in 2003. The increase in investment earnings reflects the increased value of the investment portfolio at the start of 2004 and the increase in the normalised rates of return.

Operating profit from unit trusts increased significantly from £24 million in 2003 to £53 million in 2004 as a result of both an increase in profit before distribution costs and a reduction in distribution costs.

Unit trust profit before distribution costs was £13 million higher at £75 million. Overall weighted sales of unit trust products, at £86.4 million, were £45.3 million, or 34 per cent, lower than the £131.7 million achieved in 2003. Regular premium sales were down 20 per cent at £32.6 million and single premium sales were 41 per cent lower at £538.4 million. The largest decrease in unit trust sales was within the branch network reflecting a change in mix of sales and the reduced number of authorised sellers following a revision of the Lloyds TSB Group’s suitability rules. Unit trust sales via independent financial advisers were broadly flat and sales by direct channels increased due to success in retaining customers with maturing products and successful sales of Corporate OEIC’s. The fall in sales volumes lead to a reduction in new business income but this was more than offset by an increase in income from existing business, as the improved stock market performance over 2004 has lead to higher fees, together with lower incentive payments and other cost savings. Unit trust distribution costs were £16 million, or 42 per cent, lower at £22 million compared to £38 million in 2003; this decrease reflects, in particular, lower commission payments to the branch network following the sharp fall in sales via that channel.

2003 compared to 2002

The operating profit of the life, pensions and unit trust businesses in 2003 fell by £110 million, or 21 per cent, to £411 million from £521 million in 2003.

New business income increased by £83 million, or 27 per cent, to £396 million. Weighted sales of life and pensions products increased by 1 per cent as sales volumes were affected by weak demand as consumer confidence in long-term savings products remained low. However there was a further change in the product mix towards higher margin regular premium protection policies with the emphasis upon sales of lower margin single premium life products being reduced.

The new business margin, defined as new business contribution divided by weighted sales, improved to 25.8 per cent compared to 19.2 per cent in 2002. The increase in distribution costs was also higher than sales volumes; these costs were up £42 million, or 21 per cent, to £241 million partly reflecting the increase in the proportion of sales made through the comparatively more expensive independent financial adviser channel and also the higher levels of commission payable on sales of the more profitable products.

Regular premium sales amounted to £337.9 million, or 56 per cent of total life and pensions weighted sales, compared to £286.3 million, or 48 per cent of the total in 2002, an increase of £51.6 million. Weighted sales of regular premium pension products increased by £24.0 million as improved sales through the IFA channel, reflecting both Scottish Widows’ marketing initiatives and investment in this channel, more than offset a reduction in sales through the branch network which have been affected by weak demand. Sales of regular premium life products increased by £27.6 million mainly as a result of higher sales of term assurance and savings products; sales of mortgage-related products providing life cover on repayment mortgages continued to improve, reflecting the buoyant housing market and the resulting strong growth in mortgage lending.

Sales of single premium products fell by £450.7 million, or 15 per cent, from £3,089.0 million in 2002 to £2,638.3 million in 2003. Single premium life product sales decreased by £685.1 million as a result of further reductions in sales of investment bonds due to low stock market values and adverse media comment and the closure of an investment trust in the first half of 2003 due to a lack of suitable quality investment opportunities. This was partly offset by strong growth in single premium pension business; sales rose by £218.9 million or 21 per cent as a result of the improved performance of stakeholder pension products. Sales of single premium annuity business increased by £15.5 million, or 3 per cent, following pricing changes in 2002.

Unit trust sales were £132.7 million, or 12 per cent, lower at £948.3 million compared to £1,081.0 million in 2002 as consumers continued to view investments in equity-based products with caution.

Weighted sales of life, pensions and unit trust products were £733.4 million compared to £767.6 million in 2002. By distribution channel, sales through the branch network fell by £71.8 million, or 20 per cent, to £278.8 million mainly reflecting the significant reductions during 2003 in sales of single premium life and pensions products and unit trusts. Sales of regular premium products were broadly unchanged as initiatives within the branch network resulted in an increase in term assurance sales, which offset a fall in sales of pension products. Branch network sales during 2003 were affected by significant restructuring activity in the personal sector regulated sales force, to reflect lower levels of new business and improved cost efficiency, which resulted in a reduction in its size of almost one third. Direct sales decreased by £6.3 million as a result of lower single premium product sales in difficult market conditions. However, sales through the IFA channel improved by £56.2 million, or 17 per cent, to £391.6 million with particularly strong growth in regular premium products reflecting the benefits of the investment made into this channel in 2002 and earlier. In the 2003 IFA Service Awards, Scottish Widows achieved a five-star rating in all categories.

Existing business profits fell by £158 million, or 45 per cent, to £192 million from £350 million in 2002. Within the expected return a reduction of £39 million reflecting a reduction in the value of in-force business and a lower discount rate was offset by lower restructuring costs in 2003. There was a reduction of £168 million in the benefits from changes in actuarial assumptions and experience variances. It is common practice for life assurance companies to regularly review the detailed assumptions that support the embedded value calculations having regard to recent experience. In 2003 there was a charge of £75 million in respect of actuarial assumption changes compared to a credit of £78 million in 2002, reflecting the capitalisation of pension scheme contributions, following their recommencement in 2003, within the Lloyds TSB Group’s embedded value calculations and benefits in 2002 from revisions to the assumed shareholder tax rate and the valuation of unmodelled products which have not been repeated. Experience variances were £15 million worse as a result of a deterioration in lapse and persistency rates.

The decrease in existing business profits was partly offset by a £105 million reduction in the level of additional provisions required for redress payments to customers.

Normalised investment earnings fell by £61 million, or 29 per cent, to £153 million from £214 million in 2002 reflecting a reduction in the expected rates of return in the low interest rate environment in the UK.

Unit trust profits were £24 million compared to £48 million in 2002. Income in the unit trust business is derived from both initial charges at the point of sale and annual management fees which are calculated as a percentage of the unit trust funds. During 2003 unit trust profit before distribution costs fell by 33 per cent following the reduction in weighted average sales, which were 24 per cent lower, and a fall in income reflecting lower annual management charges as the depressed stock markets caused fund values to reduce. Unit trust distribution costs fell by 14 per cent as a result of the fall in sales volumes.

General insurance

	2004 £m	2003† £m	2002† £m
Premium income from underwriting:			
Creditor	**114**	104	107
Home	**442**	410	350
Health	**27**	43	44
Reinsurance premiums	**(29)**	(22)	(15)
	554	535	486
Commissions from insurance broking:			
Creditor	**377**	351	426
Home	**30**	30	44
Health	**19**	16	17
Other	**160**	207	160
	586	604	647
Operating profit	**160**	153	117
Investment variance	**8**	13	(60)
Profit before tax	**168**	166	57

† Restated, as explained on page 26.

2004 compared to 2003

The operating profit, calculated as explained under 'Operating and financial review and prospects – Line of business information – Summary' from general insurance was £160 million, an increase of £7 million or 5 per cent from £153 million in 2003.

Premium income for underwriting was £19 million, or 4 per cent, higher at £554 million compared to £535 million in 2003. Creditor insurance premiums were 10 per cent higher, as a result of increased sales of the asset finance loan protection products, in part underwritten by the general insurance operations, and home premiums were 8 per cent higher following increases in premium rates and improved retention. Premium income from health insurance decreased from £43 million in 2003 to £27 million in 2004 as a result of the continuing run down of the book. Reinsurance premiums increased by £7 million to £29 million, in part due to growth in the underwritten property business.

Broking commissions decreased by £18 million, or 3 per cent, to £586 million in 2004 compared to £604 million in 2003. Creditor insurance commissions were £26 million higher following renegotiation of rates with external underwriters and an increase in average loan and credit card balances insured; business loan protection income was lower following claw-back adjustments on terminated policies. Home commissions were flat and Health commissions were £3 million higher at £19 million. Other commissions decreased by £47 million to £160 million in 2004 from £207 million in 2003 following a reduction in profit share income from the unusually high levels in 2003.

Investment income was £8 million higher, following increased interest rates as the majority of the investment portfolio is cash based.

Distribution commissions payable to the branch network were largely unchanged; the proportion of sales sourced through the network was lower than in 2003, but this has been largely offset by the passing on of the benefit of improved profit sharing terms agreed with third party underwriters.

General insurance claims, at £224 million, were £12 million, or 5 per cent, lower than £236 million in 2003. Claims on home policies were lower due to the favourable weather conditions in 2004 and health claims have declined as this book is run down. The underwriting claims ratio improved from 42.4 per cent in 2003 to 38.4 per cent in 2004.

2003 compared to 2002

The operating profit from general insurance in 2003 was £153 million, an increase of £36 million, or 31 per cent, compared to 2002.

Premium income from underwriting increased by £49 million, or 10 per cent, to £535 million as a result of continued strong growth in income from the sale of home insurance products which rose by £60 million. An increase in average sums assured has more than offset a decline in sales volumes, particularly through the IFA channel, as commission rates became uncompetitive; sales volumes started to improve in the final quarter of 2003 as commissions payable were increased. Creditor insurance premiums were £3 million lower and reinsurance premiums increased by £7 million due to increased rates in the reinsurance market and higher underwritten premiums.

Commission income from general insurance broking fell by £43 million reflecting a £75 million reduction in income from creditor insurance products as personal loan sales volumes within the branch network started to slow and an allowance of £35 million was made against the clawback of commissions by the insurance underwriters as loans are settled early. Income from sales of home insurance products fell by £14 million due to more competitive offers from other market participants. These factors have been partly offset by a £47 million improvement in other commissions reflecting a significant increase in the level of retrospective commissions receivable from underwriters as the favourable economic conditions have improved the profitability of the policies written.

Investment income was £9 million higher at £54 million, compared to £45 million in 2002.

General insurance claims were £7 million higher at £236 million compared to £229 million in 2002. The claims ratio fell from 45.7 per cent to 42.4 per cent reflecting the beneficial effect of generally mild weather conditions although this did cause an increase in subsidence related claims in the second half of 2003.

Operating expenses and commissions payable to the branch network were £37 million lower overall. The proportion of both underwriting and broking sales sourced through the network was lower in 2003 than in 2004, there were also reductions in advertising and severance costs and these factors more than offset the impact of annual pay reviews.

Changes in economic assumptions

Lloyds TSB Group accounts for the value of the shareholder’s interest in the long-term assurance business using the embedded value basis of accounting. The embedded value comprises the net tangible assets of the life assurance subsidiaries and the present value of the in-force business. The present value of the in-force business is calculated by projecting future surpluses and other net cash flows attributable to the shareholder and discounting the result at a rate which reflects the shareholder’s overall risk premium.

When projecting future surpluses and other net cash flows Lloyds TSB Group makes a series of assumptions about long-term economic conditions. In order to maintain comparability with other listed insurers in the UK, the Lloyds TSB Group reviews these assumptions at each reporting date.

The economic assumptions have been revised at 31 December 2004 as follows:

	2004	2003	2002
	%	%	%
Risk-adjusted discount rate (net of tax)	**7.40**	7.60	7.35
Return on equities (gross of tax)	**7.17**	7.45	7.10
Return on fixed interest securities (gross of tax)	**4.57**	4.85	4.50
Expenses inflation	**3.76**	3.80	3.30

The revised assumptions have resulted in a net charge to the profit and loss account in 2004 of £2 million (2003: a charge of £22 million).

Investment variance

In accordance with generally accepted accounting practice in the UK, it is Lloyds TSB Group’s accounting policy to carry the investments comprising the reserves held by its life companies at market value. The reserves held to support the with-profits business of Scottish Widows are substantial and changes in market values cause significant volatility in the Group’s embedded value earnings, which are beyond the control of management. Consequently, in order to provide a clearer representation of the underlying performance, the results of the life and pensions business are separately analysed to show an operating profit including investment earnings calculated using longer-term investment rates of return, and annual management charges based on unsmoothed fund values. The investment variance represents the difference between the actual investment return in the year on investments backing shareholder funds and the expected return based upon the economic assumptions made at the beginning of the year, and the effect of these fluctuations on the value of in-force business. The effects of other changes in economic circumstances beyond the control of management are also reflected in the investment variance. A similar approach has been adopted for Lloyds TSB Group’s general insurance business.

In 2004, there was a positive investment variance of £147 million (2003: positive £125 million, 2002: negative £943 million) reflecting increases in stock market values during 2004; the FTSE All-Share index increased by 9 per cent in 2004 compared with a 17 per cent increase in 2003. The benefit of improving stock markets was limited by the lower equities content in the long-term assurance funds and a reduction in the rates of return on fixed interest investments.

Wholesale and International Banking

	2004	2003†	2002†
	£m	£m	£m
Net interest income	**1,966**	1,875	1,970
Other income	**1,641**	1,561	1,520
Total income	**3,607**	3,436	3,490
Operating expenses	**(2,090)**	(2,048)	(1,939)
Trading surplus	**1,517**	1,388	1,551
Provisions for bad and doubtful debts	**(193)**	(306)	(489)
Amounts written off fixed asset investments	**(52)**	(44)	(57)
	1,272	1,038	1,005
(Loss) profit on sale of businesses	**(15)**	865	–
Trading results of businesses sold in 2003	**–**	318	279
Profit before tax	**1,257**	2,221	1,284
Cost:income ratio*	**57.9%**	59.6%	55.6%
Total assets (year-end)	**£112,968m**	£101,286m	£117,066m
Total risk-weighted assets (year-end)	**£71,143m**	£62,792m	£73,000m

† Restated, as explained on page 26.

* Excluding trading results of discontinued operations; see note 2 to the financial statements.

2004 compared to 2003

Profit before tax from Wholesale and International Banking in 2004 was £964 million, or 43 per cent, lower at £1,257 million compared to £2,221 million in 2004. However, comparisons are distorted by the substantial profit on disposal of businesses of £865 million in 2003, compared to a loss of £15 million in 2004 and, in 2003, the trading results of the businesses sold in that year. Adjusting to exclude profits and losses on sale of businesses and the results of discontinued operations, profit before tax in 2004 was £234 million, or 23 per cent, higher at £1,272 million compared to £1,038 million in 2003.

Excluding discontinued operations, net interest income was £91 million, or 5 per cent, higher at £1,966 million compared to £1,875 million in 2003. Average interest-earning assets were £8,095 million higher than in 2003; however much of this increase relates to the growth in fine margin reverse repurchase agreements held for liquidity purposes. Excluding these balances, average interest-earning assets, excluding discontinued operations, were £578 million higher, reflecting growth in Wholesale partly offset by some reductions in the International businesses. Average balances in the asset finance business were £1,314 million higher, as a result of strong lending growth, and corporate lending balances grew by £1,536 million; however, balances, within the Treasury function fell. The net interest margin was 12 basis points lower, again largely reflecting the growth in very fine margin reverse repurchase agreements. Excluding the average reverse repurchase agreement balances from the calculation, the net interest margin was 10 basis points higher reflecting margin widening in corporate banking and asset finance, where lending growth has been in the higher margin consumer portfolios, only partly offset by reductions in business banking where competitive pressures have lead to a tightening of lending margins.

Other income, excluding discontinued operations, was £80 million, or 5 per cent, higher at £1,641 million compared to £1,561 million in 2003. There was a £50 million increase in gains on the sale of assets, largely the realisation of venture capital gains, and improved dealing profits, particularly in respect of currency transactions entered into on behalf of corporate banking customers. Increased activity lead to higher levels of corporate banking lending and other fees and to higher company registration income. Overall operating lease rental income was lower, due to a change in mix towards traditional lending in the asset finance business, and a reduction in income also arose following the rationalisation of the Lloyds TSB Group’s motor dealerships in 2003.

Operating expenses, excluding discontinued operations, were £42 million, or 2 per cent, higher at £2,090 million compared to £2,048 million in 2003. Staff costs were higher as a result of business growth, particularly in corporate banking, annual pay awards and higher levels of performance related bonuses. Operating lease depreciation was £45 million lower, as a result of the change in mix of business in asset finance, and there were cost reductions following the rationalisation of the Lloyds TSB Group’s motor dealerships.

Provisions for bad and doubtful debts, excluding discontinued operations, were £113 million, or 37 per cent, lower at £193 million compared to £306 million in 2003. The charge within the asset finance operations increased in line with business volumes but this was more than offset by a reduction in corporate banking, where the improved business environment lead to several large releases, and in International following the release of £30 million from the general provision that was held in relation to the Lloyds TSB Group’s exposures in Argentina.

Amounts written off fixed asset investments were £8 million, or 18 per cent, higher at £52 million compared to £44 million in 2003 as a result of growth in the venture capital portfolio.

2003 compared to 2002

The profit before tax of Wholesale and International Banking increased by £937 million to £2,221 million in 2003 including a profit on the disposal of businesses in New Zealand, Brazil and France of £865 million. If this gain and the trading results of the businesses disposed of in 2003 are excluded there was an underlying improvement in profit from continuing operations of £33 million to £1,038 million.

Total income from continuing operations decreased by £54 million to £3,436 million. Net interest income fell by £95 million to £1,875 million. Within the Wholesale businesses net interest income fell by £74 million reflecting the implementation of the Competition Commission’s SME report remedies: the provision of interest-bearing current accounts to small business customers has caused the margin to fall by 24 basis points, reducing net interest income by £169 million. There was also lower income from treasury activities as the interest rate cut in the early part of 2003 and flattening of the yield curve reduced market opportunities. This more than offset the effects of strong growth within the asset finance operations which resulted in an increase in net interest income of £99 million; average asset finance balances increased by £991 million, mainly due to the continued demand for consumer credit in the UK, and the margin widened by 48 basis points. There was also an increase in income from structured finance transactions following the growth in balances during 2002. In International Banking there was a decrease in net interest income from continuing operations of £21 million; net interest income fell as balances were reduced, particularly in Latin America, as the Lloyds TSB Group sought to reduce its exposure to these economies.

Other income from continuing operations increased by £41 million, or 3 per cent, to £1,561 million as a result of a £105 million increase within Wholesale. This principally reflected the inclusion of income from the sale of cars by the Dutton-Forshaw Group following its acquisition in December 2002, increasing income by £51 million, and gains of £34 million on the sale of a number of leases by Lloyds TSB Leasing where the tax attributes could be used by the purchasers. There were also increases in the level of gains realised on the sale of venture capital investments and fees from corporate, asset finance and factoring activity; however, this was partly offset by a £36 million increase in commissions paid to motor dealers by the asset finance operation, reflecting the growth in levels of new business, and lower income from company registration activities. In International Banking, other income from continuing operations fell by £64 million mainly as a result of a £28 million reduction in profits from the sale and leaseback of premises. There was also a reduction in fund management fees and lower income from Argentina as the level of activity was reduced.

Operating expenses from continuing operations increased by £109 million or 6 per cent. In Wholesale there was an increase of £110 million; the inclusion of the Dutton-Forshaw Group accounted for £44 million of this increase. Within Corporate Banking there was a £39 million increase in costs. Operating lease depreciation increased by £19 million as an accelerated charge was recorded following the reassessment of the carrying value of a small number of operating lease assets and there were higher staff and risk management costs, although this was partly offset by lower reorganisation costs. There were smaller increases in other areas of Wholesale principally relating to staff and consultancy costs to support a number of major projects. In International Banking operating expenses from continuing operations reduced by £1 million.

The provisions charge from continuing operations fell by £183 million to £306 million. The charge within Wholesale fell by £78 million as the level of new provisions required against corporate customers reduced. In 2002 provisions totalling some £100 million were made against large US exposures which were not repeated to the same extent during 2003. In the asset finance business the provisions charge was largely unchanged despite strong lending growth during 2003, as the high level of voluntary terminations experienced in 2002 were not repeated during 2003. Within International Banking the charge from continuing operations fell by £105 million mainly as a result of a reduction of £79 million in the new provisions required against the Lloyds TSB Group’s exposures in Argentina as the economic conditions in that country started to stabilise. There was also a reduction in the charge in other Latin American operations as specific cases requiring provisions in 2002 were not repeated.

Amounts written off fixed asset investments fell by £13 million to £44 million reflecting lower charges against both corporate and venture capital investments.

In 2003, a profit of £865 million arose on the sale of The National Bank of New Zealand, substantially all of Lloyds TSB Group’s businesses in Brazil and its French fund management and private banking businesses. The trading profits of those businesses, the discontinued operations, in 2003 were £39 million or 14 per cent higher at £318 million, compared to £279 million in 2002, as a result of a £46 million increase in income (particularly reflecting volume growth and favourable exchange rate movements in New Zealand, more than offsetting some margin erosion) coupled with a £5 million reduction in operating expenses; these favourable movements more than offset a £12 million increase in bad debt provisions.