MORGAN STANLEY EUROPEAN FINANCIALS CONFERENCE WITH CHARLIE NUNN – PRESENTATION TRANSCRIPT
(amended in places to improve readability only)

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Charlie Nunn, Group Chief Executive, Lloyds Banking Group
Alvaro Serrano, Managing Director, Morgan Stanley, (Moderator)

Alvaro Serrano
Thank you, everybody, for coming to this session with CEO of Lloyds, Charlie Nunn. As usual, we're going to open with a polling question. Question is: Lloyds has updated its RoTE targets to 13 per cent in 2023/2024 and over 15 per cent by 2026. What do you think stands out most about the business plan?
1. The structural hedge and balance sheet structure delivering a resilient NIM medium term?
2. Strategic initiatives delivering additional revenue growth?
3. Cost discipline despite the inflation environment?
4. Resilience in asset quality shown across portfolios?
5. 175 to over 200 basis points of capital generation guidance?

Looks like the resilient NIM, but there's also a few other replies, which I'm sure we will speak to. With that, Charlie is going to make some opening remarks. I have a few questions for him, and then we'll open up to general Q&A. Charlie, do you want to go ahead?

Charlie Nunn
Thanks, Alvaro, what a great question, by the way, because obviously the answer is all of the above. But we'll get to that, as we go through this, in a minute. It's great to be with you today. It's great to be with you in a time of solidity and no uncertainty around us. The start of the year has been fun. I'm sure we're going to have some questions around that. And I also understand Credit Suisse is talking in the room next door, so you're showing your colours if you're here versus there. But thanks for joining this morning.

I'll just give a few opening messages, and I'll just talk about the key messages from our financial results, end of year results, that we did two or three weeks ago just to set some context. And it's just these five points, which actually, you really just teed up nicely for us, that it's worth talking about.

As you know, I joined 18/19 months ago now, and last year-end results, in 2021, we announced a new strategy for Lloyds Banking Group, grounded in our purpose of Helping Britain prosper. The first point is actually just to say that purpose, the focus on our customers, and then the broader impact we have serving businesses, individuals, families, which I think is always really important for a systemically important bank to have a really clear narrative and a proven point of impact, has proven very, very important in the last year. The way cost of living has impacted the UK, the focus on supporting businesses around investment and growth, the support for our colleagues and our communities has really played out. And I won't give you the stats, but there's a set of really important ways that Lloyds Banking Group in 2022 supported customers in the context of the cost of living, built financial resilience and enabled businesses to continue to invest looking forward in what is a very uncertain environment, as you know.

Second call point is around our financial performance. My guess is you got a chance to see that. I have a CFO who comes up with a different set of adverbs for every results session. This time it's 'robust'. But I hope what you did see was a robust set of financial performance. If you look underneath the performance and actually at the performance overall, our return on tangible equity was 13.5 per cent. We had very strong capital generation, last year 245 basis points. The business was growing and taking advantage of the interest rate cycle, which was important. We continued to show very strong BAU cost discipline whilst we ramped up the investments. And the net of that was we increased our dividend 20 per cent, and we announced a £2 billion share buyback.

What I've taken away from this is, now 18 months in, we do have a very resilient customer base. We have very strong underlying financials. And we are in a position where we can continue to invest for the future. We can support customers in what we are predicting to be a mild recession over the next 24 months. And we are demonstrating we want to return, through our Board, material capital distribution to our shareholders, and hopefully 2022 reaffirmed that for all for you. And I'm sure we'll get into the detail of what that looks like.

We also reaffirmed our strategy. We announced Lloyds Banking Group's strategy on the day that Russia invaded Ukraine, you were just saying this conference is always around a big event. I was very nervous that there was going to be some big geopolitical event in my second big results strategy. What's been really interesting from my perspective is I've obviously gone with the team and looked back at the strategy we announced last year. And our belief is that the initiatives we committed to: (i) really doubling down on the strength of our core franchises today in our client group businesses; (ii) driving growth and diversification, we'll come back to later I'm sure, which we've committed to £1.5 billion of additional revenue of which 50 per cent would be other operating income so would diversify into new sectors and segments in the UK; and (iii) then investing in more medium term efficiency initiatives. That strategy is even more important when I look at what we're facing today than it was on the 24th of February 2021.

And it's been an interesting year for me. When you manage a £900 billion asset bank, you have to manage the bank, with 26 million customers, for through-the-cycle returns. And very simply, the dialogue last year was all about when is peak NIM coming and how are you leveraged on the way up. We are well positioned for that, but you need to be asking me the questions about what happens when the economy softens and when rates start to come down.

What our strategy now gives us is just a very, very strong medium term perspective which says as rates start to calm down, we're going to see real momentum coming out of our stable retail funding base and our structural hedge, which really builds strongly. We have got the best and most leveraged asset base in our markets with a good mix of assets between Commercial and Retail, and secured and unsecured, which is the only way you manage through the cycle returns on both sides of the balance sheet. And we're a year into growing our revenues by £1.5 billion. Those three things together really give us confidence about the next three to five years, and hopefully that's come through in what you are seeing.

We're only a year into a five-year strategy. I would characterise the first year as a good start. We can see the early signs, green shoots of growth. But a lot of what we've done is pretty foundational, and I've totally restructured the bank. We've brought in a set of new talent. The ways of working are starting to feel different inside the organisation, which gives me confidence that we can operate with a different level of pace and intensity and focus around our customers. And we've kicked off about £900 million of additional investment last year, which is peaking this year. So a good start to a new strategy. My commitment to all of you is really clear, which as I've always said, you're not going to believe us as a management team until we start delivering quarter on quarter, and that's what we're planning on doing. So we'll continue to update on it.

The result of all that is we upgraded our financial outlook and guidance for Lloyds Banking Group. I suppose the key measures which were kind of summarised in the questions just now, is we increased our return on tangible equity target for 2024 and 2026 by 300 basis points. So circa 13 basis points for 2024, and greater than 15 per cent in 2026 looking forwards. And then our capital guidance, we’ve said about 175 basis points for the next two years, but greater than 200 basis points from 2026 forwards. And that’s founded in the momentum that you can hear I’m talking about building, through the balance sheet.

I won't talk about this now, but we'll get back to it. But just for those who aren't close to Lloyds Banking Group, we have a really clear set of areas where we are differentiating and growing, and that's what we're investing in and that's what I'll continue to talk to you about. But I think given everything's that is going on, Alvaro, I might stop and go to Q&A. And I'm going to shamelessly, if you can put me back to the first slide, leave up our lovely branding piece to look at whilst we're talking, for those who like horses, which I love.

Alvaro Serrano
Maybe we can start off with one of the last points you made. You reminded everyone that you've increased the RoTE targets by 300 basis points to 13 per cent and above 15 per cent RoTE in 2026. That's obviously very healthy profitability, but for me, one of the things that stands out is the growing profitability despite lower rate assumptions. Maybe you can speak to that resilience in profitability. And in light of the events of the weekend, any update on the state of play, how you see the world, is this going to be that significant? We're going to touch on competition for the funding and deposits later on, but maybe some opening remarks to contextualise that.

Charlie Nunn
Let me try and keep it simple. I'm sure there'll be more Q&A around this later. The strengthening confidence we have around our profitability in the medium term is really linked to what I just said with additional build, and the question tees it up nicely. The first is when we look at the strength of our customer base, we see real resilience still. I'm sure we'll talk about our provisioning for the economic cycle we're going into, and we are seeing the very, very early stages of some of that. But overall, the customer base is very, very resilient. And the fact that we have a very high percentage of retail deposits as Lloyds Banking Group, and we're the leader in every retail product that has any meaningful scale and relevance to profitability, means that we have a very different dynamic than some other institutions actually in the UK, and certainly Silicon Valley Bank. We have more than 65 per cent of our deposit base as retail, as opposed to I think it was 7 per cent for Silicon Valley Bank.

What that means is we can use that deposit base to invest in the structural hedge. The structural hedge as we exited 2022 was returning 1.13 per cent. So you will have seen in our baseline economics, we are below the yield curve, or at least we were below the yield curve until last night, I think we still are, where we were assuming that base rates in the UK will peak at about 4 per cent this year and then settle at about 3 per cent, and then be relatively stubborn at 3 per cent, because we had a view over the last three or four months that inflation will be a bit more stubborn than the market was predicting. So the first big thing is, if we can invest as the hedge rolls off at anywhere above 2 per cent there's really meaningful uplift from a revenue perspective. That's the first thing that gives you confidence.

The second is what I said, I've been leading banks in inflationary environments for my whole working career and the last 10 years with my previous colleague, Noel. And when rates go up, liability margins widen and asset margins tend to shrink, and when rates go down, the opposite happens. And what you need to manage a good customer outcome and financially your revenue line is good leverage, so your loan-to-deposit ratio being healthy. But more importantly, that you've got a strong client base that is well diversified across the different types of lending so you can respond to competitive dynamics, and as you know, Lloyds Banking Group has a fantastically diversified lending portfolio. And as I've come in, I've realised the way that that's been managed over the last decade is with very good and strong origination standards.

Then the third thing is, you want to see that there's some additional growth. And that's where we need to continue to prove to you that we are delivering on the additional revenue growth. We announced these strategic commitments of around £700 million of additional revenue in 2024, £1.5 billion in 2026, and I love the percentage weightings, because you can do the maths and realise the structural hedge will be a bigger benefit than the strategic initiatives. But at some stage, the tide will go out on banking, we've lived that for the last decade of rates, and that incremental customer-driven growth with a more diversified set of fee and non-fee based income is going to be really important. So those are the first three dynamics on the revenue line.

You need to have strong cost discipline, and you will see we have committed again to an absolute cost target in 2024. We're not immune to inflation, I'm sure we'll talk about that later. But you need to have strong cost discipline, and that's been one of the joys around inheriting Lloyds Banking Group. It's a team that understands how to manage costs. And we're now able to invest for some medium term efficiencies, and that's what we've built within the plan. Then obviously capital efficiency and the recycling of capital out of lower returning assets and businesses or segments into higher returning businesses and then some of our strategic initiatives we announced to increase the velocity of our balance sheet last year is really important. So you can get the revenue leverage without the capital drag. It's the combination of those things that give us confidence to upgrade our capital distribution targets, or at least our capital generation targets, for 2024 and 2026.

Now there's lots to play out over that period of time. But that's been founded on a set of baseline economic assumptions that I think are appropriately prudent or conservative. I said to you last year, I'm a CEO, and our management team is a team that wants to not just make our numbers look good by taking the easy external assumptions and then focus on the controllables. So I'm not going to give you very, very easy base rate assumptions that make our numbers look better. We have given what I think are appropriately prudent and conservative baseline assumptions. And then we'll try and focus on what we can control which is; how do we grow the business, and manage the costs, and build capital efficiency going forward.

In terms of what's happened last week, the weekend was very busy. But you've spoken to Noel, so you all know that. It's obviously very, very interesting. What's happened with SVB I think is relatively idiosyncratic relative to the UK. You'll be having your own discussions around other medium sized banks in the U.S.. But certainly, it's completely different from us, obviously relative to the way our balance sheet is formed, the nature of our customer franchises and then our own strategy around managing the liquid asset portfolios that underpin our liabilities. And if you want to go there, we can.

The change shift we have started to see, the flight to quality shift in the U.S., we haven't seen that starting here. But I'm not surprised because I think most of the retail and business community outside of life sciences and tech, the whole SVB thing and SVB UK is not really a main event. But I think it's going to be very interesting to see how that dynamic plays out in our customer base over the next three to six months. I don't know how that's going to play out. I have a clear view, based on having managed banks through rate cycles, around what was going to happen independently of this event. But given Lloyds Banking Group and our customer base, I'm not concerned it's going to be a negative on us. If anything, I think that would be a positive.

And then in terms of the impact on the rates and bonds markets, again, there's many people in this room who are going to be better at forecasting this than me. It does feel like it's a slight overreaction at the moment in some of the adjustments. But I'm never one to discount the information that comes through the markets. I think that we all need to see what's coming next. I think in the U.S., it's more complex because the actions the Fed has taken are quite structural on how banking works. Obviously, the fact that HSBC made it easier in the UK means I don't think we have those issues.

And I think the important thing is when I look at the shift in the yield curve, which underpins some of Lloyds Banking Group's economics, the market hasn't yet come down to our baseline. So nothing that's happened yet compromises the foundations of what I've just told you, as to why our customer base is resilient, the growth initiatives I've just talked about, our structural hedge taking advantage of the assets out of the balance sheet as rates start to decline, and then our growth initiatives. Nothing's compromised by what I've seen yet. So we'll have to see how the MPC responds based on whatever data we see in the next few weeks and then over the next few months. And when then the peak of base rates is going to be, we still don't know.

Alvaro Serrano
Maybe we'll touch on what I think pre-SVB captured the market's attention in the UK, which is all the banks are pretty much guiding to peak NIMs. There's a liability and an asset component to that guidance. Maybe we can start on the deposit side. At the full year in the call, I think you mentioned that you had taken pricing action, and with that pricing action on deposits you expect them to be stable or even grow during this year. Maybe we can discuss the deposit dynamics, whether deposits are going to other institutions, what's triggered your actions, your pricing actions, and how do you see those evolve?

Charlie Nunn
Okay. Let me start on overall NIM, and I'll then focus on deposits. The simplest version of the story for us is there are two headwinds this year and one tailwind. The two headwinds are competition around deposits and starting to pass on more of the base rate increases, which we'll come to in a second if that's alright. I'll talk about it in more detail.

The second is the mortgage margin repricing and the UK market, particularly the set of business written in 2021 during the middle of Covid at about 180 basis points. And you'll have seen the completion margins we're all talking about at the moment, Q4 and then Q1, I'm sure we'll come back to that, are significantly lower margins. So there's the headwind of that margin repricing from the mortgage book. There's a real glass half full view of that because I think we'll be through the mortgage repricing in the next couple of years, and then Lloyds competes with a completely clear mortgage book, which is a real strength for the Banking Group.

And then the real tailwind is the structural hedge. But our structural hedge is very backend loaded this year in Q3 and Q4. So when we gave the guidance of greater than 305 basis points of NIM for this year, we then had to do some explaining to say how does it come up that high after Q1, then drop down because of the two front-loaded headwinds I just discussed. And then it stays relatively flat in terms of how we're thinking about it for the year, and based on our numbers, so far never goes below the 300 basis points. So that's the dynamics.

On deposits. So far, deposits have played out pretty much as we thought they would, how we guided last year, and I'll give the view around that in a second. The one caveat around all of this is no one has a crystal ball, and this market hasn't been through a rate cycle for 15 years, so no one knows what the elasticity curves are for different segments of the customer base in the UK, bluntly. So we're all going to have to work through this together.

But what we said last year was the small business and retail deposits, which were obviously the really core part of how we generate value for you, the shareholders, through the structural hedge-eligible deposit base, they typically aren't that dynamic until you hit a base rate of about 3 per cent. That's true in every market I've operated in the world. And then depending on where the base rate goes to, and we gave guidance for about a 50 per cent pass through, what you'll see is across the different types of deposits and savings products, you'll end up with 150 to 200 basis point spread between the pass through and the base rate. So in Mexico, when I was managing HSBC in Mexico, it was a 7 per cent rate, we had a pass through of about 5 per cent. We always said the base rates would end up at about 3 per cent in 2024. But if it's 3 or 4 per cent, we'd expect 50 per cent pass through.

And typically, it takes a couple of years for balances to reposition to enable that. So part of that is financial institutions like us offering higher rates on time deposits and instant access savings accounts. And part of it is our consumers and businesses moving money from zero interest current accounts into instant access savings, or into time deposits if they have the money and the liquidity to do that. And the same with the businesses on the commercial side.

So what happened was actually almost exactly as we thought would happen, which is when base rates got above 3 per cent in Q4 last year or just at the end of Q3, we started to see more dynamism, more activity as consumers look for a return and move money both within our bank between our different accounts and then competition to move money to other players. And that's pretty much what we've seen for the last two quarters on the retail and small business side.

And obviously, as we saw that happening, we got two base rates hikes in November and December in quite quick succession, so we took a bit of time to think about how we would compete on the products. We have launched some more products and some new pricing at the start of February. So there was a gapping benefit, if you like, that we didn't pass through, but we wanted to be able to compete in a way that we thought was best for our customers and would enable us to compete for deposits going forward.

The commercial and SME business is really different. You saw in Q4, we had £9 billion of outflows. The majority was on the commercial side. And that's much, much cleaner, there's two or three dynamics. That's a much cleaner NPV decision. There is a whole bunch of institutional deposits we either don't want or we're holding for further relationship value, and we have a very transparent discussion. There was that £4.5 billion we told you in Q3 last year that was on our balance sheet and we didn't really want it. I don't mean that as a negative, but it didn't create an NPV, and we expected it to reverse out which it did.

And then there's competition around corporates that have money to put into term deposits moving more actively out of sight deposits into term. And then there is a small set of corporates whose burn down is happening, whose payments have gone up to deal with inflation, and supply chain costs, and employee payrolls. And that's above their revenue or price pass-on, so we can see some segments actually burning down their cash. But both on the retail side and the commercial side, overall cash deposits are above where they were pre-Covid. But it's the really stressed segments that we focus on in that context.

Now what's happened last week, not much yet. We haven't seen what we have seen in the U.S., which is the flight to quality, but let's see how that plays out and we'll see how people feel over the next period of time. And January and February was a continuation of what I said, which is competition for customers that have money and are looking for return and us starting to compete with a broader range of savings products.

I think that's the point in the cycle we're at. As I said, what we'd expect is this will shift, and that is what is in our assumptions around our NIM, this will shift over the next 18 months. You will have all looked back at the UK. Even in 2014, the UK had a very, very different mix of retail and SME deposits between what was held in sight deposits, versus instant access savings, versus term deposits. There was a very, very different mix just 10 years ago, and I would expect to continue to see that shift over the next few years. And that's what we've got in our numbers.

Alvaro Serrano
I think you called out in the full year results that 50 per cent beta in the interest rate-sensitive deposits. Help us think through, reassure us around the assumption, maybe how you come up with that number. In light of the events, do you think that deposit beta could go up, could differentiate between players? Maybe if there's a long lasting effect of what's happened over the weekend, maybe helps us think about that.

Charlie Nunn
Yes, I'll help you think about it. It's difficult to predict. And in fact, I know some CFOs and CEOs refuse to predict NIM, as you know. But I think the first issue, which is differentiated between the bank, is how much of the deposit base is retail versus commercial. Because the active management of commercial deposits is obviously typically higher than retail, and the sensitivity to the kind of shifts we have seen is higher, and that makes a difference. Then it's really the retail deposit base that gives you the confidence around your structural hedge-eligible products. So that's the first thing that's important to look at, and that we look at closely.

Even within retail deposits, and you know my history, different institutions have a different mix between wealthier clients, with big balances that account for a majority of the deposits, versus a more distributed mass market bank, which is what Lloyds Banking Group has where you have lots of people with less deposits. And although this is by customer, not by value, I know you all want to talk about value, 80 per cent of Lloyds Banking Group customers have less than £5,000 in either their current accounts or their savings accounts. And 5 per cent of £1,000 is £50 a year. It's irrelevant in the context of the current cost of living challenges, which is why you see less activity, less movement in those kinds of customers with those kinds of balances. That's the first thing to look at. And you can imagine, we play to our strength in that.

The second thing is obviously the distinction between current account deposits versus broader deposits. We disclosed that for Lloyds Banking Group, we obviously have a very, very material amount of current account deposits. And typically, there is obviously a segment of larger balances within that. Typically, customers are looking there for a great transactional account service, with a great digital experience, with the ability to move money in and out in whatever way they want to. And it's a free banking service. So the value exchange there isn't really interest rates. It's actually something completely different.

Then when you get into instant access or instant access savings accounts, the real question then is do people need that money for their own liquidity? Even some quite large balances, when we talk to customers, they believe they need it for liquidity if they're wealthy. Or do they have the ability to lock it up for two years, three years and put it into a time deposit?

Interestingly, the dynamic we've just seen, I don't think changes the whole current account dynamic. At the moment, if you believe the yield curve is kind of coming down, out two to five years, this will reduce the time deposit rates that are available in the market as it feeds through, if they stay down. So there may be less of an incentive to move money that way. The real question for me is how much churn is there from current accounts to instant access savings, and how much do banks need to pay to keep money in instant access savings. And that's where obviously, again, the broader relationship and the value of your relationship makes a real difference.

Savings is a very competitive market. So pre the rate rises even, we saw 5 per cent to 7 per cent of savings coming in and out, and it was a two-way flow per month. It's been that dynamic for the last decade. It's been that dynamic most of the way through my 30 years banking in the UK, certainly since the UK became a digital market. So this is what we do day in and day out, trade against other institutions for those deposits. And as you know, even in a zero base rate environment, we had attacker banks and fintechs and kind of small building societies offering 2 or 3 per cent instant access returns. So this has been a dynamic of the market all the way through the last few years.

Alvaro Serrano
Maybe let's touch on the big focus, the mortgage margins. Obviously there was a slowdown in the market last year post mini-budget. The completion margins were also impacted there. But maybe you can touch on that. And more importantly, going forward, how do you see margins evolve? Obviously, we're going to have the very profitable mortgages from Covid rolling over. Maybe you can give us some confidence and what you think is a sustainable spread there, given the ring fencing liquidity trap and the usual sort of debates around that. What gives you confidence throughout the plan?

Charlie Nunn
Great. Again, everything comes with a caveat that, as you just pointed out, there were some changes in the structural dynamic in the UK financial services that we don't fully know how they are going to play through a cycle. But let me tell you what happened and how we are envisioning it. You'll recall that February last year, we in our strategy said we thought through-the-cycle mortgage margins would fall to about 75 to 100 basis points, and that it was the basis last year for our forecast. As you will recall, we were the only bank that came out with that view, and a number of you had challenged us on that. But we had a really clear view from the very start that when rates go up, asset profit margins always decline. And then the structural changes in terms of ring fencing was going to mean more competition for assets because they need leverage on their balance sheets, the other players in the UK market. So again, as I say, we started with that.

What we saw through last year was actually a slightly more challenging outcome. Q4 was a good example. But two reasons. One was every time we saw a base rate increase the swap curve jumped up, which was obviously priced in the mortgages. And what we disclosed is our completion margins relative to a competitive 2 and 5 year swap curve, recognising that most mortgages are fixed price, and the split between 2 and 5 years has changed a bit, it is kind of 50/50. It was more 2-year recently, and it was more 5 year at the start of last year, but broadly 50/50.

So what we saw all the way through last year, was completion margins were squeezing as competitors were taking a few weeks to adjust their pricing but then they were coming back to somewhere between 70 and 80 basis points on new business and apart from the mini-budget, which I'll talk about in a second, actually, we have seen that continue into Q1. So new business margins have continued, after an adjustment in base rate, competitively to get back to that kind of range which is good. It shows that there's sensible pricing happening in the market. It's materially lower than the Covid loans, as we just discussed. But as you know, the net impact on my NIM is very positive. And that's what happens always in rate cycles. You get a lower margin on assets as rates rise, and you kind of get more on your liability. So the trade for you as shareholders is still very positive at this stage. And that's a healthy margin with respect to individual mortgages and our ability to originate them.

Now two things that have happened on top of that. In October last year when the mini-budget, September/October, when the mini-budget happened, if we call it that, because of who we are we wanted to stay in the market. And although we pulled some of our products, we wrote a lot of business around the period that the mini-budget happened. That ended up being lower margin, significantly lower margin than that, and it's where most of the volume in Q4 happened. So even though margins recovered pretty strongly in November and December, it wasn't enough volume to offset the margin dilution of that period in October. On a growth interest basis, those mortgages are very attractive, but obviously, relative to the hedging that we communicate the completion margin by, they look like low-margin business. That's the first dynamic.

And then the second one, William the CFO and I, we're just thinking about how do we help you with the disclosure going forward. We have a product transfer business, which is around existing mortgage customers, offering them a better rate to remortgage with us. We call it product transfer in the UK. The Americans call it refinance business, normally. And that's a business that we are happy to do at a lower margin because we know the risk is lower because we know the customer. And we typically have additional cross sell follow-ons, so we actually get a longer duration relationship, which provide us better returns. And not included in what I'm about to say, we have a lot of relationship value around other products if they keep their mortgage with us.

So that product transfer business is at a lower margin, and that's been a very significant part of the market as customers have been looking to deal with higher rates. When front book is at 80 per cent, you could say product transfer is around 50 per cent margin. That's diluting the total completion margins. One of the things William and I are thinking about is do we try and split that out for you going forward, or do we just stay focused on the new business margin.

But that's what's happening in mortgage market. Our view is that this year, the combination of those things will be below the 75 to 100 basis point margin that we communicated in February last year, but that's built within our NIM guidance of greater than 305 basis points. We'll have to see how this plays out, because obviously, as you all know, and you'll hear from my competitor bank CEOs, you have to look at this across the whole balance sheet through the cycle. And actually, the progression overall is very positive as we have talked about the whole way through this discussion. And that gives us real opportunities to build the client franchise and the balance sheet for through-the-cycle returns. So there's going to be some interesting competitive action through this period, but I'm pretty comfortable with that being the guidance still, and it's certainly what gives us confidence around how we're playing.

One final thing. When I came in, there were lots of things you asked me and I could say about Lloyds Banking Group. But there were two really, really obvious issues that I wanted to fix early. One was I had a much bigger legacy back book of mortgages at higher margins than I think many of you, certainly I in my own spreadsheets, discounted the value of for all the reasons that we talked about. And the second thing was I had a pension deficit of £7 billion in 2019 that bluntly was stealing my ability to distribute capital to you as shareholders. The plan that was laid out means that most of the mortgage repricing will have cleared through the system by the end of 2024. So I'm distributing more capital, I'm probably the only bank above my cost of capital in the UK, at strong returns with a better trajectory for the future whilst investing for strategic growth. And I'm clearing out the mortgage drag headwind, and that will position me really nicely from 2025 onwards to compete with a clean back book, if I can put it that way.

And the second thing is, although we're going through the triennial discussion with our pension trustees, the pension deficit we expect to be less than £2 billion by the end of last year. And that means that we're going to position to say there'll be no additional variable contributions, which is what takes capital away from the discussion with the Board around what we can distribute to shareholders.

So those two big issues, that probably you've been discounting Lloyds Banking Group's capital returns on, for a while, with everything going on, we'll have got through in the first couple of years of my tenure, which is part of the proposition. We just need to make sure everyone understands.

Alvaro Serrano
That tees me up to a very quick final question because I want to leave time for audience to ask. On the capital generation that you've alluded to, 175 basis points this year and next, increasing to over 200 basis points. That's over 10 per cent free cash flow yield, effectively. Should investors expect all of this to be distributed? As you look to invest in the business, what kind of activity, if any, would you consider as a possible use of that capital? What are your priorities?

Charlie Nunn
So, capital distributions are a decision for the Board, but obviously we as the management team take a recommendation. And we've always said we think this phase of the strategy is largely an organic plan with in-fill acquisitions where we can accelerate building capability and buying capability, which is interesting in the context of last weekend.

We have done two acquisitions. One was just completed as I was coming in, but obviously involved. One was Embark, which was a wealth digital platform player and an IFA platform. And we announced Tusker, which is a digital SME EV car leasing platform. One was £400 million, one was £300 million. Acquisition that was £400 million was Embark. Both meet those criteria, but we have said, our strategy is largely organic. And I will continue to look at in-fill capability-based acquisitions, but I'm not looking at, in this strategic cycle unless something materially changes, anything other than that. So, I think that's the first important point on kind of uses of capital that could be significant.

The second thing around distributions. I hope, and I've only done this two years, but hopefully you're starting to build confidence I am committed to capital distributions through what we did in 2021 and what we're now doing, what we've announced in 2022. You need to build confidence that the new Board under Robin and me have that commitment. But all I can say is look at what we're doing, and hopefully you'll feel the commitment is one around capital distributions, if that's what's right for the Group at that stage and there isn't a better use of the money. So we're certainly doing that.

But the final part of this is we committed to getting down to our CET1 target by the end of 2024 of 13.5 per cent. We exited last year at 14.1 per cent. We reconfirmed that commitment. A big part of that, as you'll know is, how do you maintain the confidence in your regulators and the government in how you are managing capital. And I think what you've hopefully seen with us is the provisioning we took in Q3 last year, the overall management around our risk, the positioning of the Group with respect to supporting customers and businesses in this cost of living crisis all gives us confidence, and the capital plan that we just made was obviously signed off by the PRA. So I'm very proactively as the CEO managing, how do I maintain confidence in my government and my regulators in our capital plan and our medium term capital planning so that we can continue to paydown that 13.5 per cent, and that's clearly what we recommitted to.

There was a transaction that you may not have seen. We did a £2.5 billion legacy portfolio, mortgage portfolio, sale in quite an innovative structure. And that was because it was NPV positive for us, for you, but for us from a shareholder perspective. But it also got rid of a meaningful amount of stressed assets under stress. And again, that's about medium term capital planning, giving our regulator confidence that we know what we're doing, giving you confidence that we're managing this very, very proactively.

So we're confident in the plan we've laid out. I hope you are going to have increased confidence around us as a management team and as a Board on our commitments around this.

Alvaro Serrano
We should open it up for questions. Who wants to ask the first question? There's one in the middle there.

Unidentified Participant
Morning. I just had a question on what you think the likely behaviours of the treasurer, or savers with high balances are from here? We saw the response from the earlier survey that a lot of investors here expect a response to last week's event to be increased deposit betas or more competition. Equally, somebody could say that this week, the treasurer or saver is going to be adjusted and maybe less likely to change rate or term out. What's your view as a bank executive?

Charlie Nunn
I think it's too early to say about last week. I'll just go back to what I said earlier, which is at this stage, we're not seeing a huge response amid the businesses, individuals, families, across our 26 million customers. Our experience in the past, as we all know, is if uncertainty is significant, there is a meaningful flight to quality in the UK. And we will be one of the trusted brands, and the biggest by far, obviously, given the mix and scale of our business, for that flight to quality. We haven't seen that yet. If that were to happen, that means, as you've pointed out, the pressure on having to pay to retain deposits will be less. But I'm not going to predict that at this stage, because I'm not sure. SVB is so idiosyncratic, and it's so not in the minds of UK retailers and businesses more broadly outside of the fintech and tech sector, I'm not sure that by itself will be enough. There will have to be a broader kind of narrative emerging for that to be the case, to be honest, I think.

And then the question comes, if that doesn't then drive a flight to quality, which makes it easier, we're back within the dynamic I just talked about. Which is, yes, there's been a slower growth of the big banks' deposit bases over the last year as people who are looking for return were putting money into smaller institutions. And the big banks' balance sheets have started to offer a better return in the last three months, and we're back into that competitive dynamic. And it's all about the quality of your customer base, the value you provide to them more broadly, your ability to differentiate pricing and launch products that meet customer needs to retain deposits, and then how you win on the money that is flowing between institutions. And we're the best digital bank, with the best customer base, with the best data, so I feel well placed for that competition.

The one thing I've said repeatedly and will continue to say is, nobody has a crystal ball in an economy which hasn't had a rate cycle for 15 years. I've managed businesses in every meaningful inflationary environment in the last decade, and I can tell you exactly what happens in each of those. I have no data to say what this customer base, what the UK customers will do in a higher rate environment, because what happened pre the credit crisis was very, very different.

So we kind of don't know. My commitment to you is we have laid out very clearly our view on NIM. I've given you a view that we think we can broadly manage the balances stable to potentially up. If that changes, we'll just tell you quarter on quarter. And we'll make sure we highlight what that means for Lloyds Banking Group.

I'm not worried about our underlying dynamics. We have a £25 billion buffer on top of our structural hedge as we exited 2022, and I've got £35 billion worth of the structural hedge rolling off this year even before I think of other actions. So, I've got lots of flexibility to manage this, and we have said that we think we can keep the structural hedge at £255 billion because we want that medium term engine of growth for all of us to build that medium term capital. But whether that's £250 or £260 billion is irrelevant for the value story for whatever number you pick.

So we're pretty confident today. I'm not going to sit here and tell you I can predict the future. If anything changes, we'll let you know. But it's not going to change the value story unless there's a very, very significant difference or shift in what's happening.

Alvaro Serrano
Next question. We'll squeeze one more in.

Unidentified Participant
Thank you. In the beginning of the discussion, you mentioned that you're seeing early, early signs of the asset quality issues from the softness of the economy. Can you speak more here?

Charlie Nunn
Yes. I'll try to relatively quickly. So the overall message is the customer is, and I say this, surprisingly resilient. I think when you look at the data and we look at what's happening, overall the resilience is very strong. And there's not a single part of our business which isn't still better than it was pre-Covid, which is the starting point. I think that's important.

We have a lot of ways we can look at this. We have a very sophisticated set of early warning indicators for every subsegment. And I pull out the bottom 1 per cent of the UK population by income and wealth and I look at them alone and drive a whole set of data. And broadly, the early warning indicators are very stable still at this stage. As you know, from a provisioning and a management perspective, we have provisioned against an economic scenario, which is a mild recession, 1 per cent down GDP. You can go through the numbers. And we've put £600 million worth of economic scenario ECLs on the balance sheet in Q3 last year, with another £80 million in Q4. So I'm very comfortable with the provisioning. And at this stage, we're not fulfilling that provisioning, if that makes sense. But we're very, very early in the stages of the year.

So what I was alluding to is I then, with my team, say let's go and look at the lowest income customers who have a high LTV mortgage from 2006 to 2008, the legacy book, and where are they in arrears. Actually, our unsecured book is completely stable. The other area is we know transport, agriculture and hospitality are the most stressed sectors in the UK at the moment. So go and look at the SMEs in that sector, which don't have cash flows that cover more than 1 month and see what stress you're seeing. When I go and look at those customers, I can see there's early signs that they're moving into arrears at a higher rate than they were through last period of time. But the overall level is still materially below Covid. We're materially below what I have provisioned for. The overall health of the customer base is very, very resilient.

If I sat here and told you something else, and anyone that does, they're not looking closely enough at their data, number one. Number two, I would be worried, given my forecast for the economy, which is we have got a baseline set at the end of last year which is 1 per cent down on GDP. Whether that ends up at 0 per cent or 1 per cent, this isn't a very healthy environment, and there is significant inflation going through our balance sheet. So if I weren't seeing that point of stress, I'd be telling my team to go and recut the data because I need to go and support those customers. But I'm not worried about it from a financial perspective at this stage. If it changes, I'll let you know.

Alvaro Serrano
I'm afraid we've got to leave it here, but thank you very much, Charlie.

Charlie Nunn
Thanks for having me.

END

FORWARD LOOKING STATEMENTS

This document contains certain forward-looking statements within the meaning of Section 21E of the US Securities Exchange Act of 1934, as amended, and section 27A of the US Securities Act of 1933, as amended, with respect to the business, strategy, plans and/or results of Lloyds Banking Group plc together with its subsidiaries (the Group) and its current goals and expectations. Statements that are not historical or current facts, including statements about the Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as, without limitation, 'believes', 'achieves', 'anticipates', 'estimates', 'expects', 'targets', 'should', 'intends', 'aims', 'projects', 'plans', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'may', 'seek', 'estimate', 'probability', 'goal', 'objective', 'deliver', 'endeavour', 'prospects', 'optimistic' and similar expressions or variations on these expressions are intended to identify forward looking statements. These statements concern or may affect future matters, including but not limited to: projections or expectations of the 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 Group's future financial performance; the level and extent of future impairments and write-downs; the Group's ESG targets and/or commitments; statements of plans, objectives or goals of the Group or its management and other statements that are not historical fact; expectations about the impact of COVID-19; and statements of assumptions underlying 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. Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from forward looking statements include, but are not limited to: general economic and business conditions in the UK and internationally; political instability including as a result of any UK general election and any further possible referendum on Scottish independence; acts of hostility or terrorism and responses to those acts, or other such events; geopolitical unpredictability; the war between Russia and Ukraine; the tensions between China and Taiwan; market related risks, trends and developments; exposure to counterparty risk; instability in the global financial markets, including within the Eurozone, and as a result of the exit by the UK from the European Union (EU) and the effects of the EU-UK Trade and Cooperation Agreement; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Group's credit ratings; fluctuations in interest rates, inflation, exchange rates, stock markets and currencies; volatility in credit markets; volatility in the price of the Group's securities; tightening of monetary policy in jurisdictions in which the Group operates; natural pandemic (including but not limited to the COVID-19 pandemic) and other disasters; risks concerning borrower and counterparty credit quality; risks affecting insurance business and defined benefit pension schemes; risks related to the uncertainty surrounding the integrity and continued existence of reference rates; changes in laws, regulations, practices and accounting standards or taxation; changes to regulatory capital or liquidity requirements and similar contingencies; the policies and actions of governmental or regulatory authorities or courts together with any resulting impact on the future structure of the Group; risks associated with the Group's compliance with a wide range of laws and regulations; assessment related to resolution planning requirements; risks related to regulatory actions which may be taken in the event of a bank or Group failure; exposure to legal, regulatory or competition proceedings, investigations or complaints; failure to comply with anti-money laundering, counter terrorist financing, anti-bribery and sanctions regulations; failure to prevent or detect any illegal or improper activities; operational risks; conduct risk; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; technological failure; inadequate or failed internal or external processes or systems; risks relating to ESG matters, such as climate change (and achieving climate change ambitions), including the Group's ability along with the government and other stakeholders to measure, manage and mitigate the impacts of climate change effectively, and human rights issues; the impact of competitive conditions; failure to attract, retain and develop high calibre talent; the ability to achieve strategic objectives; the ability to derive cost savings and other benefits including, but without limitation, as a result of any acquisitions, disposals and other strategic transactions; inability to capture accurately the expected value from acquisitions; assumptions and estimates that form the basis of the Group's financial statements; and potential changes in dividend policy. A number of these influences and factors are beyond the Group's control. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc with the US Securities and Exchange Commission (the SEC), which is available on the SEC's website at www.sec.gov, for a discussion of certain factors and risks. Lloyds Banking Group plc may also make or disclose written and/or oral forward-looking statements in other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group plc to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward-looking statements contained in this document are made as of today's date, and the Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this document whether as a result of new information, future events or otherwise. 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