BARCLAYS GLOBAL FINANCIAL SERVICES CONFERENCE WITH WILLIAM CHALMERS – TRANSCRIPT
(amended in places to improve readability only)

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Aman Rakkar, Director, Banks Equity Research, Barclays (moderator)

Aman Rakkar
Good morning, everyone. Thank you very much for joining us. This is the European track of the Barclays Global Financial Services Conference in New York.

We're delighted to be joined this morning by William Chalmers, Group Chief Financial Officer of Lloyds Banking Group. I'm sure you'll be very familiar with William. William, thank you very much for your time. We do really appreciate you taking the time to be here with us. And without further ado, in the interest of time, I think I'll get straight into it. So, many US and international investors with us here today will be worrying about an uncertain macro backdrop in the UK and implications for its banks. Given your unique vantage point, I'd be interested in your assessment of the operating environment, and how would you characterize the outlook for your business?

William Chalmers
Well, first of all, thank you for inviting me, Aman. It's a pleasure to be here. I'm glad to see that in a week where New York is hosting the Fashion Week, you've actually chosen the bank conference instead, which is great to see.

Anyway, Aman, the question that you pose is an important one. You will have seen – I'm sure many in this room will have seen – our Q2 economics refresh. In that context, as you know, we predicted a modestly better GDP outlook, about 0.2 per cent positive this year, as opposed to the recession, which was previously thought about. We also expect unemployment to continue to be pretty low in the fall of this year, peaking a couple of years out at around 5.3 per cent, but pretty modest throughout. The price of that is effectively higher for longer interest rates and alongside that probably slower macro growth in the years thereafter.

So, when we look at that, it is again a broadly reassuring economic picture. And the question becomes, well, what does that mean for our operating environment? What does it mean for our bank? First of all, I guess, Aman, in terms of growth, I think what it means is relatively modest balance sheet growth, relatively muted economic activity.

Second, in terms of margins, that interest rate environment is probably constructive for our margin. You saw a bit of that in the context of H1. Third, in terms of asset quality, I'd expect to see asset quality continue to be pretty robust in those circumstances. And again, you saw a bit of that in H1. And the indicators that we look at in terms of early arrears, also early warning indicators on a look-forward basis continue to be pretty benign.

Then, finally, Aman, in terms of the bottom line – ROTE and capital generation – in that environment again I think it's a pretty robust picture. You saw a lot of that in H1. We would expect that to continue, going forward. So, I think, in short, the operating environment, Aman, it's not exciting, but it's pretty benign.

Aman Rakkar
Thanks very much. If we can switch to the revenues, NIM, obviously an important part of your investment case. Your guidance for FY 23 of NIM of greater than 310 basis points, it does suggest further NIM pressure from the 314 basis points that you delivered at Q2. Can you talk to the major drivers of NIM and, indeed, revenues from here and where you see potential sources of upside or, indeed, downside risk?

William Chalmers
In the income line, as a whole?

Aman Rakkar
Yes.

William Chalmers
Sure, happy to. First of all, just to start with H1, as people will have seen, we upgraded guidance in terms of NIM at H1 to greater than 310 basis points. That was driven really by two things: mainly, by bank base rate changes that we hadn't forecast; a little bit by probably a touch better deposit performance than we had expected.

So, that's the pattern in H1. I think when we look forward, what are the headwinds? Two main headwinds. One is, again, this continued deposit shift that we're seeing, both in terms of a little bit of PCA to the savings and then also some changes within savings itself, migration within savings itself, instant access to fixed-term typically. That's headwind number one.

Headwind number two is the mortgage refinancing. Very high margin mortgages refinancing into a lower mortgage margin environment. That will taper off in 2024. But at least for this year and much of next, we've got that in place. And then in terms of tailwinds, well of course, the biggest single tailwind is the structural hedge. We've got £255 billion of structural hedge balances which are currently yielding 1.25 per cent, that are refinancing at more like 4.5 per cent plus, and they're refinancing at the rate of about £40 billion per annum. So, that is a very substantial tailwind for the margin, going forward.

Beyond the net interest income picture, what else do we see? We see other operating income, which at £2.54 billion in H1 was probably a touch above where we had expected it to be, a slightly better performance than we had expected, Aman. That's across all of the business lines: retail, commercial, insurance, pensions, and investments. And I would expect that to continue, both as a function of general economic activity, and also as a function of strategic initiatives starting to gain traction, again in each of those three business lines.

When we look at the headwinds and tailwinds, to your point, or rather the risks to the upside and the downside, what would you highlight? The macro question, how does that play out exactly. Customer behaviour, how does that play out exactly. We're pretty confident on both of those two. But nonetheless, that's a source of both upside and downside, I guess.

And then, finally, a couple of upside pointers. One, in particular, business initiatives. We've seen some decent performance in corporate and institutional UK market share this year. Likewise, the transportation business and retail has shown some decent growth, particularly following the Tusker acquisition. And then we see some positive sectoral developments in certain areas. GI is an obvious example, where we've seen rate hardening and we've seen the absence of any negative weather events, for example. So, overall, that looks pretty good, too. Those are sector developments which might augment the pattern.

Aman Rakkar
You touched upon deposits. That's a key area of uncertainty that comes up in conversations with investors I speak to. This comes amid a backdrop of rising competition, political pressure, and evolving customer behaviour. Mix shift, in particular from things like PCA into term deposits, feels like an area of uncertainty. History indeed suggests this kind of mix shift could potentially have quite a long way to go to return to more "normalized levels" perhaps pre-financial crisis. This is all the kind of thing that could impact NIM quite considerably. How do you think about this? And how concerned are you by the prospect of rising deposit costs, more broadly?

William Chalmers
Thank you, Aman. It's an important area that takes up a lot of investor dialogue, obviously. For me, the right place to start here is, just put it all into context, which is to say increasing deposit costs are an inevitable consequence of a rising interest rate environment – indeed, a nonzero interest rate environment – those two together. Now, to be clear, that is a good thing. It's a good thing because it enables us to deliver better profitability for the institution, and it's a good thing because it enables us to generate better, stronger capital return for all of you as our owners. So, it's unequivocally a good thing to see.

When we look at the patterns going beyond that, when we look at the patterns over the course of this year so far, the year to date, we've seen about £6 billion of PCA migration. We've also seen a bit of migration within the Savings book, as I mentioned earlier on, instant access typically to fixed-term - also, limited withdrawal. That pattern of movement is going to continue into Q3 and, most probably, beyond. To be clear, that is already discounted in our margin guidance, and what we put out there, if you like, encompasses what we've seen. And the performance to date as we look into the third quarter right now has been very much in line with our expectations, as I've just said.

So, over time, however, that pattern will start to taper, and it will start to taper because, (a), we'll see bank base rate prompts, if you like, for savers to move money start to peter out. Secondly, we'll see that the hot money, for want of a better phrase, that was going to move in the context of rising interest rates has already moved. And thirdly, we'll see instant access rates start to increase and, therefore, offset some of the shift that we've seen within fixed-term.

And then, on the other hand, we'll see some offsets take place. We're already seeing the effect of inflationary wage settlements within the overall deposit book, for example. Customers typically will hold higher precautionary balances in the uncertain world that we seem to now be in versus where they might have been before. Likewise, you'll see macroeconomic growth leading to deposit balances increasing. And then, finally, as you know, we have many strategic initiatives, some of which at least are targeted at relationship building, with the objective of enhancing deposit balances both in the retail space and indeed in the commercial space. And so, those will be offsets. And over time – it's hard to call precisely when – but over time, therefore, the types of migrations that we're seeing today will start to taper.

What if we're wrong? When we model sensitivities that look at if we are wrong, what happens and what happens if we go back to something that is closer to the 2010-type proportions of things like PCAs in our overall retail book? When we look at it in that context, again the spreads are offset – the spreads that we lose in the structural hedge are offset by the spreads that we gain in terms of fixed-term, in terms of limited withdrawal. Likewise, the spreads that we gain on the structural hedge that stays in place are typically higher in that type of environment. And so, there are some material offsets.

And I think in that context, therefore, it's very important here just to not lose the wood for the trees, as it were. We're seeing an interest rate picture which is consistent with better profitability and, indeed, higher capital returns for our owners.

Aman Rakkar
Just to round out the discussion on deposits, the UK has implemented Consumer Duty as of the end of July. The regulator seems to be taking quite an interest in the assessment of fairness of the customer proposition; in particular, a 14-point action plan on cash savings. Interested in your thoughts on Consumer Duty, the impact that it could have on your business, the industry more broadly, and in particular, the impact on customer savings rates to legacy back-book products.

William Chalmers
Thank you, Aman, again an important topic. For those of you in the room not from the U.K. regulatory backdrop, Consumer Duty was introduced as of July of this year. It was pretty well trailed in the years preceding that, and so we've had a long time to kind of get used to it.

The reason I say that is because, again, to cut to the bottom line, Consumer Duty is effectively confirming or more or less codifying what it is we do in the business already. That is the bulk of Consumer Duty. Alongside that, it seems to me very likely, to us very likely, that over time Consumer Duty probably plays to the advantage of the large-scale players and maybe to the disadvantage of some of the more marginal or higher-charging players across the piece.

Why do I say that? Well, Consumer Duty effectively is an all-embracing regulation which requires you to treat customers fairly. It won't surprise any of you to know that that is an objective that we have always aspired to. And so, as Consumer Duty comes in, it's not clear to me that it necessarily changes terribly much as to how we go about business.

Specifically, Consumer Duty asks you to put forward a so-called value framework for your customers. When we look at our customer propositions, we look at price, we look at access, we look at distribution. These are all factors which lead us to make customer-based decisions which, in turn, are entirely consistent with the value-based framework that Consumer Duty calls out and asks us for.

You mentioned the Savings Action Plan, which, in a sense, is an extension of the Consumer Duty principle, Aman. What we're seeing there is a lot of further obligations to notify customers, to prompt customers to do things with their money in the context of the rate environment that we're in. If you've signed on to our app anytime recently, you'll see we're doing a lot of that already. And so, we see these things as at the margin incremental, but not really changing the objectives or necessarily the reactions of the institution.

Consumer Duty is about transparency. Overall, it's a good thing. And as I said, we think we deliver it already. Consumer Duty, as I said, we think will benefit scale players over time, of which we consider ourselves to be one. So, overall, I think, Aman, we see it, we obviously pay close attention to it, and we will evolve with it. But that's what it is. It's about evolution, not revolution.

Aman Rakkar
Thank you very much, William. We do have a bunch of Audience Response Survey questions. You'll see the remote handsets kind of sitting on your desk. And if it's okay, I think we'll take a couple of questions to kick things off.

Question 1 – What would cause you to become more positive on Lloyds shares: (1) positive NII surprises; (2) more fee income; (3) better cost savings; (4) better asset quality; (5) bigger distributions; (6) clarity on UK macro; (7) clarity on political uncertainty.

William Chalmers
All things that we would aspire to

Aman Rakkar
That's quite a lot of answers, though, isn't it? Okay. That's very interesting. So, by some way, I think the standout response there is clarity on UK macro. It's quite an all-encompassing answer, isn't it? I don't know if that's a great surprise?

William Chalmers
Well, I think it's very consistent with our understanding. When we look at the operating performance of the business, as I mentioned earlier on in relation to your question, Aman, it feels to us basically very reassuring. We're doing pretty much what we said we'd do. The challenge that is a little bit out of our control is obviously the UK macro, and it's that that we look to for not just enhanced opportunities for business, but also a greater sense of stability in the equity markets and, indeed, to reduce the cost of equity.

I think the only answer there where there's a word that I'd like to say is not part of our vocabulary is the word 'surprise', on the first one. One of our big objectives in life is to deliver predictability for people, and although we can't ban surprises altogether, we certainly don't want to see too many of them.

Aman Rakkar
Great, can we shift to Question 2 – What are you most concerned about at Lloyds: (1) weaker earnings; (2) weaker capital; (3) lower distributions; (4) regulatory risk; (5) political risk? I think that's quite interesting. I think it's more evenly spread. The most popular answer is political risk, followed by weaker earnings, and then not far behind, regulatory risk.

William Chalmers
I thought regulatory risk and political risk might dominate a little bit more there, actually. Weaker earnings, we've given guidance, and I hope that that is what informs your expectations around the stock and your appraisals of it.

In essence, we're seeing earnings as we have profiled for the course of 2023 and 2024, and then we see significant operating leverage kicking into the business in the years after 2024 as the headwinds that we've seen – particularly, mortgage refinancing – play out and as the income tailwinds – in particular, refinancing the structural hedge aligned to strategic initiatives – kick in. And that's what drives the operating leverage of the business, which, in turn, leads us to a stronger earnings and, indeed, capital generation and repatriation level going forward into 2025 and 2026.

Aman Rakkar
Can we go to Question 3, as well, please? Clearly, a key driver of the earnings outlook. 'How do you think about Lloyds' NII into '24: (1) growing, driven my loan growth; (2) growing, driven by structural hedge; (3) flat; (4) falling, given headwinds; (5) given other headwinds?' So, (4) is deposit headwinds; (5) is other headwinds.

Interesting, most people kind of seem – obviously, the greatest standout response there, growing given the hedge. But it's, I guess, balanced by concerns around deposit headwinds.

William Chalmers
I mean, Aman and I didn't rehearse these questions before. But any question about 2024, as those that tuned into the conference call will know, is a bit of a trap, really, because we tend to comment on guidance in '23, but not so much a year out, other than the guidance that we gave in February 22 and updated earlier on this year.

That outcome doesn't terribly surprise me. I mean, I think we'll see how things go. We'll see how the interest rate environment develops. We'll see how deposit migration from our earlier comments develop. I think one important component which you'll be aware of, again, is that the mortgage refinancing tailwind plays itself out in the second half of 2024. And so, where we see the real operating leverage developing is in the years thereafter.

Aman Rakkar
Of course, you didn't fall for our trap then to try and get '24 guidance out of that?

William Chalmers
No, having resisted it for the conference call, I resisted it there, Aman.

Aman Rakkar
So, we talked about the hedge. It's a key tailwind for the business. It's a unique characteristic of balance sheets in the UK. You're reinvesting balances at much higher yields. You do also have falling balances. Hedge notional is guided to fall by high single digit billion pounds this year. I guess that's driven by an uncertain outlook for things like current accounts. Can we talk about this hedge tailwind and, indeed, if you see any risks to fully realising what seems to be a pretty significant multiyear tailwind?

William Chalmers
Yes, happy to. Again, I think just to cut to the chase, when we look at the structural hedge it is a very substantial tailwind, going forward. We've got circa £255 billion of balances. Again, yielding 1.25 per cent, that will be yielding into the kind of 4.5 per cent-plus range as we refinance.

We expect the size to reduce. As you say, Aman, we've given indications for a single-digit billion reduction during the course of this year. And indeed, things are playing out currently in conformity with that expectation, in line with that expectation. Having said that, our guidance again is informed by that expectation. And even despite that expectation, we still see the structural hedge as generating in excess of an £800 million income tailwind per annum. That's after having adjusted for those size expectations that we talked about earlier on. It is, as said, likely that deposit changes, deposit migration, is going to, first of all, steady and then start to taper over time, and that's down to the factors that I mentioned earlier on.

We also take a look at say, as I said earlier on, what happens if deposit migration is greater than we expect? Well, again, the structural hedge still provides a very significant income tailwind even in those circumstances. It is also worth saying that the structural hedge is not some Lloyds idiosyncratic earnings factor. This is a sector-wide phenomenon. Everybody has a large structural hedge within the sector. And so, if there is a sense in which deposit migration changes well beyond people's expectations, which is clearly not the base case, but if that were to happen, you could expect to see that engender a sector-wide response in terms of pricing of other financial assets elsewhere to customers.

So, we should not lose sight of the fact that this is an industry-wide phenomenon which, in turn, informs the competitive pricing of the industry, not just in terms of deposit products, but really across the board. And I hope that's some source of comfort. As I say, from our perspective, the structural hedge will be, no matter what, in any plausible non zero rate environment, a source of significant income tailwind on a multi-year basis.

Aman Rakkar
Thanks very much. If we shift to mortgages, a key part of your business, we've seen lending volumes fall for two consecutive quarters amid a difficult backdrop characterized by subdued demand and pressure on front book spreads. How are you navigating this kind of challenging operating backdrop? And indeed, what's your strategy here? Are you actively prioritizing NIM over volumes?

William Chalmers
I think the best way to answer that question, Aman, is to say it is always our intention that we will deliver both growth and, indeed, manage returns in a way that is consistent with our shareholders' best interests. So, we will always manage growth and returns in a way that is consistent with shareholders' best interests.

That is the case, while recognizing that we want to be a long-term player in a market where we see ourselves as having a structural competitive advantage. We are, at the end of the day, the biggest player within the UK mortgage market, and we expect it to remain that way over time. And that gives us a structural competitive advantage.

It's worth just putting the trends in the open book into context in that respect, Aman. That is to say, we saw about a £0.7 billion reduction in the open book in Q2. To put that into context, that's off the back of a £298 billion open mortgage book stock, and so, these are pretty small movements that we're seeing.

I think within any given quarter you're going to inevitably see some ebbs and flows in terms of the performance of the open book. Often that is in relation to phenomena or events that took place several quarters previous to the actual quarter in which we are reporting, simply because it takes time for applications to migrate into completions. And indeed, you've seen that a couple of times this year.

The underlying strategy, however, remains the same, which is again that we want to stay a major player in this sector in pursuit of our overall purpose. And so, when we look at our strategic plans and our strategic initiatives, in particular, Aman, what are we doing in that respect in the mortgage market? Well, we are developing some product areas which will help us build relationships with our customers; again, whether that is in respect of deposits, whether it is with respect to insurance, whatever it might be – that's point one.

Point two is we are developing subsector specialisations. You've seen us be pretty active in the first-time buyer market, for example, over a number of years. That is indeed where we aim to continue; that, alongside one or two other subsectors which we see as favourably advantaged from a margin and a risk point of view.

We also aim to enhance the remortgage capability, a critical part of the UK mortgage market, particularly in times when new mortgage balances are relatively few and far between, relatively slow markets like the one that we've got today. And then, finally, we've got a great setup in terms of channels. And so, delivering kind of ever slicker channel experiences and optimising between channels is a further part of our mortgage strategy.

And so, those are the types of things that we're doing in the context of our strategic transformation. Those are the types of things that will see us remain and, indeed, consolidate our position as a major player within this attractive market, consistent with our purpose. But within any given quarter, as said, you may see some ebbs and flows.

It is safe to say that, over time, you'll see that position consolidate, alongside the strength that we've seen in H1 in some of the other retail areas, whether that's cards, whether it's unsecured, whether it's motor. So, that's the pattern, and that's the commitment.

Aman Rakkar
Rounding out the discussion on revenues, last year's strategy update saw a significant increase in investment through to '24 and an ambition to grow revenues by £1.5 billion by 2026. And that was roughly evenly split between NII and fee income. How is that progressing? And how confident do you remain in achieving this target?

William Chalmers
An important question, Aman. I'm sure everybody is aware, but we are engaged in a very significant strategic transformation for Lloyds right now. We pledged to invest an incremental £3 billion in the years up to 2024. That will turn into £4 billion in the years up to 2026, in addition to our regular BAU investments in terms of what we describe as legal, regulatory, and mandatory and discretionary. So, it's an extra £3 billion to '24; £4 billion to '26, on top of that.

What are we trying to achieve by making those investments? A couple of points really. One is revenue growth and diversification; so, enhanced revenue growth and diversification. Two is we are trying to enhance, if you like – build – both cost and capital efficiency. And then, three is we are trying to maximize the potential of what we describe as our enablers, whether that is people, whether that's data, whether that's technology. These are the enablers that enable us to deliver a more promising, better-returning business.

When we look at it, we are now seeing the signs of traction, which is good to see. We're about a year, a year and a half into our strategic plan, and we're starting to see some signs of traction and delivery. So, if you look in the retail area, for example, we've already made investments that launched earlier on this year, which are significant contributors to the ambitions of both the retail segment and also the insurance, pensions, and investments area.

Likewise, we've just launched something called mobile onboarding, which greatly reduces the time for a new customer to join our business and commercial banking capability offering. That is now reduced significantly versus where it was. It's a significant achievement over the course of the first half of this year.

And then alongside of that, as you've seen, we've also started to expand capability and, hence, market share within the C&I area. So, overall, we're seeing some good, healthy, and significant signs of traction in terms of delivery.

There are one or two areas as well where we've actually surpassed some of the expectations for 2024, mainly in the non-financial area. So, digitally active customers, for example, we've surpassed our ambitions for 2024. And having done that a bit early, that causes the question, were the targets demanding enough? And how can we go further? Likewise, one or two other areas, a similar type of analysis.

Stepping back into your question on revenue and cost targets, which is where all this stuff hits the bottom line, Aman, as you say, when we look at that, to be clear, we've got lots to do. But as we stand today, we feel very comfortable, very confident about hitting our 2024 revenue and cost ambitions and, likewise, hitting our 2026 revenue and cost ambitions as a function of the strategic transformation that we're engaged in right now.

For those that are interested, we're launching a bunch of seminars during the course of this autumn and going into the spring to enable you to take a closer look at what we're doing in each of these areas. I think the Consumer update is coming up first, which will encompass the relationship side, broadly speaking, the savings and deposit side, and the lending side, doing what it says. That will, I think, be October of this year. Hopefully, it will give you some insight. I've no doubt it won't give you enough numbers. But nonetheless, it'll give you some insight into what it is we're doing and, from there, how we're delivering on the strategy.

Aman Rakkar
Great. I'm going to ask one more before going back to the ARS questions. So, I'll ask one more question to William first. Around asset quality, it's a key topic of discussion in investor meetings that I have particularly over in the US. Clearly, there's an uncertain outlook for the UK economy, high-profile step-up in borrowing costs for mortgage customers, in particular, in the UK and an uncertain outlook for interest rates, how long they're going to stay high. But the remarkable observation is how benign things have been so far and the confidence that comes around the messaging on asset quality from yourself and your peers. Where does this confidence come from? And are you seeing any signs of stress emerging in your portfolio?

William Chalmers
It's an important question. In short, Aman, the confidence comes from performance, and that includes both historic performance but also the performance of look-forward factors.

I'll elaborate on that. When we look at the overall business, we're very happy with asset quality. We're very happy with portfolio performance. And we're very happy with the way in which what we describe as early warning indicators, which is the range of kind of horizon factors that we look at on a look-forward basis. We're very happy with how all three of those are developing.

If you look at the H1 charge that we took, it's around £662 million. That's about 29 basis points of our portfolio and pretty much in line with the guidance that we gave for the asset quality ratio of circa 30 basis points this year. More precisely, if you take a look at Q2 to get a kind of more mark-to-market view of what's going on; you can see there, first of all, the £419 million charge, which includes multiple economic scenario, IFRS-driven, non-impairment-related charges.

But beyond that, you see an observed charge of £335 million, which is the actual default experience, if you like, that we're seeing. Now, that's 29 basis points. But actually, if you scratch beneath the surface of that, there's a couple of, roughly speaking, non-impairment type factors going on. One is bank base rate discounting of future recoveries for existing impairments, which is not a new impairment point; it's rather a function of the interest rate environment that we're in. And the second is the so-called Stage One roll-forward, which, as you know, is a function of future economic expectations as opposed to actual default experiences.

So, you strip that one out, and you're down to about 26 basis points of underlying impairment charge, if you like. Under a similar analysis, that is very similar to what we saw in Q1 and also in Q4. So, no deterioration within that line.

When we look beneath that, as highlighted at the H1/Q2 reporting period, we talked a little bit there about some deterioration in our legacy mortgage portfolio. And it's true, we've seen a little bit, but it's pretty modest in its overall scope. And if you go beyond that, the rest of retail and, indeed, all of commercial is performing in a very benign way; certainly, in line with our expectations. So, the picture looks pretty good.

Aman, we then said, look at a range of so-called early warning indicators. And it almost doesn't matter which one you look at. You get a similar, very stable picture. So, you can look at early payments, for example – sorry, minimum payments – within the cards book as an example. You can look at debtor days on invoice finance. You can look at the behaviour of insurance policies and are they paying up early in order to give the customers cash and so forth.

Again, across the board, we're seeing a picture that is, (a), benign and, (b), stable. I guess one might ask the question, why do we think that is right now, as you did, Aman? And I think some of it is down to our prime customer base, which you've heard Charlie and me talk about ad nauseam, I'm sure you feel. But nonetheless, we talk about it a lot. And it is a prime customer base, and that is now showing through.

I think the second point is we have a pretty cautious set of underwriting standards. Again, you've heard me talk about that a lot over the course of the years, the stress testing that we do when customers come in and take a loan out, and all the rest of it. Pretty cautious underwriting standards in terms of the customers that we take and also in terms of the customers that we don't take on the asset side of the book.

And then, finally – or thirdly, I suppose – which is not Lloyds brilliance, but we're in a low-unemployment environment. And in a low-unemployment environment, we typically don't see very significant defaults. And going back to respond to your first question, Aman, we see that low-unemployment environment as continuing. It might tick up a little bit, but overall, the picture is pretty benign from an unemployment point of view.

So, I think that's why we're seeing the performance of the book as it is. Now, what happens if we're wrong? What happens if all of what I've just told you doesn't pan out to be quite what happens in reality? Well, underneath that we have what we believe is a very high quality book. And it's not just me who says that, but you can actually see it in the objective stats that we produce. LTVs within commercial, for example, 42 per cent. Very high levels of interest coverage ratios on the commercial book. Again, a very highly collateralized book, whether it's an SME or whether it's investment-grade in the commercial book, for example. So, a very high quality book which protects us from any downturn.

And then, finally, what happens if the worst comes to worst? Well, as you know, we've got a £5.4 billion ECL, expected credit loss, on the books right now from provisions that we've taken over the course of the last few quarters. That number, £5.4 billion, is £700 million in excess of our base-case expectations for provisions that would be necessary in our base-case economics. So, it's a prudent provision, and it is also buffered by an excess because of the probability-weighting methodology that we deploy in ECL above and beyond whatever might come out of base-case losses.

So, I think, Aman, this is very much a situation where the experience is benign, the outlook is benign. We think we've got a prime-quality customer base. On top of that, we think we've got a very high quality book. And finally, if things go wrong, we think we're very well provisioned.

Aman Rakkar
Excellent, I'm going to return to the ARS. We're going to jog through these. Question 4 – How do you think Lloyds will perform versus market expectations for capital and dividends: (1) beat expectations, given better earnings; (2) beat expectations, given lower capital requirements; (3) miss expectations, given earnings; (4) miss expectations, given higher reg requirements?

Beat expectations, given better earnings. That's a pretty emphatic response there. It probably speaks for itself.

William Chalmers
Well, it's one I probably shouldn't comment on, isn't it, Aman?

Aman Rakkar
Question 5. What do you see as the biggest risk to Lloyds' earnings? I think this is in the context of what I would characterize as a low share price, a subdued valuation. So, I think it is interesting to probe where this sensitivity comes from. What do you see as the biggest risk to Lloyds' earnings: (1) rate cuts; (2) competition; (3) cost inflation; (4) loan losses; (5) government or regulatory intervention?

Interesting, so, evenly split: competition, loan losses, government or regulatory intervention - bank taxes, obviously, very topical.

William Chalmers
It's an interesting one. I mean, another manifestation of it is why the share price is where it is and what's behind the implied very high cost of equity that comes out of that. And of course, from our perspective at least, it is hard to understand why the share price is the way it is in the context of the returns that we expect the business to generate over the coming periods. I'm sure that won't surprise any of you.

When we look at it, two or three reasons why that might be, I suppose. Competition for deposits is one point that is noted down here. As I said earlier on in my comments, we can't really see any plausible nonzero rate scenarios that causes a problem of a scope that is anticipated by some of the conversations.

Second, in terms of loan losses, you'll be able to tell from the comments that I gave just a second ago it feels people are expecting something which is wholly disproportionate to what we expect to see. And then, occasionally the politics comes in, which is point five here. But in a sense, isn't that related back to deposit performance and some of the debate that's going on in that space?

So, when we look at it, it is hard for us to understand the cost of equity that is being implied by the current share price. Now, we're takers. There's nothing we can do about that. Except for we can continue to ensure the business delivers predictable and robust returns, number one; and then, number two, try to clear out any capital blockers that might be between those returns and getting the money back to you as our owners. That entails dealing with legacy issues in the main. And if we do that, then hopefully over time the cost of equity will sort itself out.

Aman Rakkar
Great, and Question 6, final ARS question – How would you view significant acquisitions at the group level: (1) very positive, given potentially higher return on investment; (2) marginally positive; (3) marginally negative; (4) very negative; (5) prefer the capital back to shareholders? Interesting.

William Chalmers
That's helpful and I think broadly as I guess I might have expected. I think the way in which we see acquisitions for the group is we will look at things that either enhance capabilities – and we saw that a bit with the Embark acquisition last year, the salary sacrifice scheme in the transport area that we bought with Tusker this year – or, alternatively, enhance scale. When I first came in, we bought a mortgage book off Tesco, which is a UK supermarket. It helped us in scale on mortgages, and we were obviously a lower-cost provider.

But all of these transactions are small. In the scheme of things, they're small relative to the scale of the earnings of the group, relative to the capital generation of the group, and relative to your capital returns. So, they're all pretty small.

How do we look at them? We look at them in terms of we know what our strategic objectives are. So, will any of these things accelerate the speed that we can achieve those objectives at? Can any of them be done at an acceptable risk? And thirdly, and perhaps most importantly, can any of them be done in a way that accrues value to our shareholders? And those, for us, are pretty high bars. And so, the strategy is organic. That's first, foremost, and also last. In between, there might be room for the type of acquisition that we've seen over the course of recent periods, but I doubt that it will be any more significant than that.

Aman Rakkar
We're running short on time. We've almost hit the end point. I'm going to sneak in one real quick one here at the end, on that theme of capital returns. At 14.2 per cent, your CET1 ratio is strong; it's ahead of your 13.5 per cent target. You're capital-generative. You're going to end the year with a surplus cap position. You announced the £2 billion share buyback this year. It was a big number, but I do know that you completed it at the end of August. It does seem – it seems like the outlook for surplus distributions is positive, indeed. It seems like the market could absorb a bigger number than £2 billion. I mean, anything that can say on the outlook for surplus distributions, in particular?

William Chalmers
Sure, sure. Perhaps, first, just kind of starting out with a couple of entry points, Aman. As you, the capital stock is pretty strong, 14.2 per cent as of the half. Capital generation also feels very robust, circa 175 basis points for the year, of which a substantial proportion was delivered as of the half.

It's good, it's good to see that capital generation, it's good to see a strong stock, because it allows us to finance any regulatory capital requirements; you saw a bit of that in H1. It allows us to finance both organic and occasionally inorganic growth within the business; again, you saw the Tusker acquisition in H1 as evidence of the inorganic piece. And it allows us to invest in a strong and, indeed, growing return to all of you as our owners; and you saw the 15 per cent increase in the interim dividend over the course of H1. So, capital generation is important. It allows us to achieve those three objectives and maybe more.

When we look at it, the capital return policy, Aman, which is the heart of your question, very much remains as we have always said it, which is to say a progressive, sustainable dividend policy, alongside an assessment of and, indeed, commitment to return excess capital at the end of each financial year.

Within that, the buyback is a really important component. As you say, we closed the buyback just recently, actually. Over the course of that £2 billion, we bought back stock, which effectively gets rid of close to 6 per cent – over 6 per cent, in fact – of the stock of the company. So, it's quite a significant achievement, that buyback.

That overall capital return policy allowed us to deliver £3.6 billion in respect of last year to shareholders. That £3.6 billion, I'm afraid, rather depressingly, is about 13 per cent of our market cap. I wish it was less. But nonetheless, it's a significant achievement. And as said, the buyback's role in that is important. It cancels out over 6 per cent of the stock this year. If you looked at it the last two years, '22 and '23, the combined buyback after share issuance has actually gotten rid of almost 11 per cent of the company's stock. So, it's really very, very powerful.

We recognize within that the preference of our owners. They want to see buybacks. And it's understandable, because we also recognize within that the value opportunity. The current share price, it delivers real value, we believe, to our owners. So, it's an important commitment. It'll continue to be one, and I expect to see more of it, Aman.

Aman Rakkar
Okay, excellent, okay. Thank you very much for your time, William. We do really appreciate it. Thank you, everyone, for joining us this morning, we will end the session here.

William Chalmers
Thank you very much.

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. 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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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