LLOYDS BANKING GROUP PLC – 2020 FULL YEAR RESULTS – SELLSIDE ROUNDTABLE – TRANSCRIPT
(amended in places to improve readability only)

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William Chalmers
Welcome to everybody to the Roundtable Call for this year end. We are happy to take questions in the order that they come up in and the operator will take questions and feed them through. So welcome again and we look forward to the conversation.

Question 1 – Rohith Chandra-Rajan, Bank of America
Hi good afternoon and thank you very much for doing the call. I would like to ask a few on the structural hedge because obviously it is a big part of the revenue mix and evolution over the coming years. The first one is just a clarification. So structural hedge income was £2.4 billion in 2020 and if the notional doesn't change and it is reinvested at five years then at current rates income would fall to around £1.1 billion over the next five years or so. First I would like to check that is broadly correct and I appreciate there are moving parts there.

Secondly on the phasing. So one third of the hedge rolls this year and income falls about 17 per cent based on the number you have given and you are indicating less decline in income in 2022 and 2023. I am trying to square that, the numbers that you have given us for this year would suggest something like 130 basis points yield on the £60 billion that is rolling off. It would be really helpful to get an idea of the volume and the yield on maturities in the subsequent years to help with the modelling of that revenue profile for the structural hedge please.

William Chalmers
Okay thanks for the question Rohith. I am going to go through the guidance that we gave on Wednesday but I am not going to go further out than that other than some of the more generic comments I will make. In 2020 we had £2.4 billion in earnings from the structural hedge. Over the course of 2021, we indicated that we will see a £400 million headwind in the structural hedge earnings. Now based on the yield curve that we have to date it may be that we are a little better than that i.e. that we are less than £400 million in terms of the structural hedge headwind and that is because the £400 million was essentially an indication based upon the status of the yield curve with the balances that you have locked in for performance as of that date. Now a) we don't have all of the balances in terms of maturities locked in at the current yield curve, that is a process that will take its time over the course of the year. And b) we have yield curve movement that is going on all the time and as you saw it happened last week too.

In terms of the pattern on that, I mentioned that the 2022 year will see significantly lower levels of maturities and shorter dated maturities more importantly. And as a result the impact in 2022 is less than the impact 2021. And then 2023 is slightly longer term maturities and slightly greater in terms of volume of maturities in that year. We would expect 2023 to be above 2022 rather than necessarily in line with 2022. So 2022 is a quieter year than 2021. 2023 then picks up a little bit. But I will not go beyond that in terms of the overall profile of the hedge. You know the weighted average life of the hedge and the overall earnings from the hedge. We talked at the third quarter around the hedge that lasted around five to six years. Since then we have put on some longer dated maturities and so it has got a longer total life even though the weighted average life is as we described on Wednesday.

In terms of the second part of your question, the phasing, I partly answered that already and I don't really want to get into yields on the hedge profile over the course of this year or going forwards. Safe to say the comments and the remarks I have already given, gives you enough to be working on in terms of the income profile.

Rohith Chandra-Rajan
Thank you. I mean it is a little frustrating that for the other banks where it is more of an automatic roll process. We can have a decent stab at what the profile is and it is obviously a big moving part from an NII perspective, but I appreciate

you don't want to give a lot more. To summarise your comments, £0.4 billion step down, maybe a little less this year, less than that in 2022 and then perhaps picking up from 2023 onwards with the remainder backend loaded, is that the right summary of what you just said?

William Chalmers
Without putting numbers on it. 2023 is likely to be less of a headwind than 2021 but probably more than 2022, again without putting numbers on it. And then the hedge goes up in profile more or less as you described it before, a little bit more long dated stuff that was put on recently in the five to ten year zones simply because we have seen it as appropriate to get value from that end of the curve. Now the one point that you make about others having a rolling hedge or a caterpillar hedge approach versus us. As you say it may make it easier to model. But two points, one it delivers a lot less value than other hedges and we believe that our dynamic approach both enhances earnings stability, and delivers shareholder value number two because we do sit back and earn reward from investing at longer dated periods.

The second is that even if we gave you guidance today, i.e. on Monday 1st March, because it is a dynamic hedge it is going to be out of date in a few days time. And so whatever we can tell you today will require a daily mark to market for it to be up to date and adequate for modelling purposes. I will tell you what I can tell you today Rohith, but you will understand that because of the way we manage the hedge it is never going to be modelled in the same way as other more caterpillar approaches are.

Rohith Chandra-Rajan
That is okay. Could I ask just one final thing, you have given us the gross hedging income for the full year 2020 of £2.4 billion which on the average balance per year looks around 130 basis points. What was that in Q4, just thinking about how I should think about that during the course of this year in the margin guidance you have given?

William Chalmers
Sorry I didn't fully understand the question Rohith.

Rohith Chandra-Rajan
What was the hedge yield in Q4? For the year as a whole it was about 130 basis points, I was curious as to what it was in Q4 in particular given that it has been moving around again?

William Chalmers
I won't give you a precise number in terms of the yield but you will have seen the earnings during the course of Q4 of around £440-500 million over the course of the balance of the hedge during that period so that is probably the best way to get there.

Rohith Chandra-Rajan
Okay, thank you.

Question 2 – Ben Toms, RBC
Good afternoon. Thank you for taking my questions. On the top end of your RoTE guidance for FY21, could I ask what cost of risk level the top end of the RoTE guidance assumes?

Then secondly you have given some more colour on property footprint reductions in the slides which includes 20 per cent office space reductions by 2023. What is the size of the potential cost savings that you think you can extract from this and would you expect branch closures at a similar kind of rate? Thank you.

William Chalmers
In terms of the RoTE guidance Ben, as I understand your question, you were asking about the consistency between the impairment guidance and where we were at the top end of the RoTE guidance. It is fair to say that we have looked at the RoTE guidance in terms of ensuring that we feel confident in delivering what we set out. We looked at the impairments guidance in much the same way. So when we look at the RoTE guidance you might pick a midpoint of that guidance and say that is consistent with us being reasonably confident around delivering the impairments. I won't put an exact parameter on it. But we said less than 40 basis points for AQR guidance. We feel confident that it will be lower than that. We put 40 basis points as guidance number to ensure that we do deliver. The midpoint of our RoTE guidance being roughly consistent with our overall level of confidence in the AQR. And so again without being too precise about it Ben you might match those two up to some extent.

As I said on Wednesday, we feel pretty comfortable in terms of the overall impairment guidance as we look into 2021 and we have given some indication around where we developed prudence and caution. So hopefully that gives you a sense.

In terms of your question on property costs. I will not put an exact number on the property costs that we have built in, but I will address the second of your two questions around branches. We have a multi-channel strategy and that is the intention going forward. It is our intention that we will maintain the largest bank branch network in the UK. I think it probably goes without saying given our overall status as the largest retail and commercial bank in the UK. But that does not mean that we will not take a look at branches. We have in plan a number of branches that we will review during the course of 2021. And we see a degree of branch rationalisation as entirely consistent with our multi-channel approach. That in turn will also help with our cost plans.

Ben Toms
Thank you.

Question 4 – Aman Rakkar, Barclays
Good afternoon William. Just a couple of questions please on cost to start with. I appreciate you might be somewhat hesitant to talk too much about 2022 costs. You guided 2021 to 7.5 billion versus consensus and I think consensus is looking for 7.3 in 2022. You have some temporary elements to your cost base in 2021, which hopefully will fall away, some of them are Covid related. Is there anything from where you're sat right now to think that you couldn't hit something like a 7.3 billion cost base in 2022?

Related to that I was interested in your view on headcount. The last couple of years you have been running down headcount about 4-5 per cent per annum. I think it was 2 per cent in 2020. Interested in your medium term thoughts about headcounts. Should we be looking for a higher run rate for head count reduction in 2022 when the backdrop is a bit more favourable?

The second question on NIM. I note from the call the other day you intimated that there is a bit of a trajectory to NIM in 2021 and perhaps an interpretation of that is it could be lower in Q4 than it is at the start of this year. When we look into 2022, do you think NIM might be bottoming out at these levels? You have got a lower structural hedge impact, hopefully you have got mortgage repricing to offset some of the pressure on SVR attrition. Then you have hopefully got the positives from consumer credit balances rebuilding. Should we be thinking about flat lining in 2022 perhaps or even some NIM progression? Thank you.

William Chalmers
First in terms of costs, a couple of points to make. As you say the start point is the cost discipline of the organisation which remains undiminished. You saw the costs come down circa £300 million across the course of 2020. That was a significant achievement. And you have seen our continued commitment at £7.5 billion in 2021, which will continue to be a significant achievement for a number of reasons including not least of which some headwinds that I talked about on Wednesday in the form of Covid costs and remuneration, which we expect to see increase during the course of the year. That continued commitment to get costs down to circa £7.5 billion, continues to be a reflection of our discipline around the cost base.

As we look forward, we have a couple of things going on. One is the BAU cost process, which is a matrix approach, this allows us to deliver across the organisation whether it is third parties automation, organisational design in total and that puts continued pressure on run rate costs. Above and beyond that to the point you made Aman, is that we see a number of Covid related costs which in turn induce short term pressures in the cost base. Hygiene is one example of that. The needs to equip our colleagues to work for home is another example of that. And those in turn also over the slightly longer term will introduce opportunities either as those headwinds run off or alternatively because they allow opportunities in terms of property or distribution. The Coronavirus related costs will be short-term pressures, longer-term opportunities.

Then there is the whole strategic question around the investment in new technology, for example in investment distribution. The answer to your question around the 2022 cost base again without putting a number on it, is how quickly those headwinds runoff. Now there is one of them that I would hope starts to be mitigated sooner rather than later which is the Coronavirus related costs, which include things like hygiene as I said before. It will also include things like customers in financial difficulty type pressures. How many staff do we need to put into the branches, into the system to help the customers in financial difficulty? Well that depends upon the macro and how that runs off. Our 2022 cost framework will be influenced by that type of development. The progress of the virus and the macroeconomic damage induced by the virus. If it is less, it certainly helps in terms of mitigating some of the cost pressures.

Remuneration is a double edged sword because on the one hand we will see that build up during the course of 2021 and I would to a degree hope that we see a bit more build up during the course of 2022 because it will be part and parcel of better and stronger results for the company as a whole. We will see how those two go. One is determined by the macro and the other is determined by the profitability or otherwise of the company.

On the headcount. Overall our headcount as you say has been on a downward trajectory. Our cost plans continues to be around things like automation, smarter ways of working and organisational design. I would hope that is consistent with a progressively managed down FTE count, or headcount. That will be an area to invest in for sure, new business opportunities, certain technology areas and so forth and those will be offset. Overall, our focus will be on measures that are likely to result in continued containment of the headcount.

On net interest margin for 2021, a couple of comments. First of all you are absolutely right. I tried to point out a fair picture where there is a little bit more pressure on the margin in the second half of 2021 than there is in the first half. That is partly just because we are coming off a very, very strong Q4 in terms of the overall margins. We came out at 246 in Q4 2020. We have given guidance in excess of 240. That does suggest that our Q1 off the back of strong mortgage margins, the rate trends you are seeing and reductions in RCFs in the corporate and institutional side, we will see a bit more continued strength in the first quarter. Then we will see a little bit more pressure in the second half as illustrated.

I will not give guidance in terms of 2022 margin expectations, but I think some of the dynamics that you are pointing to in terms of the SVR book running off, the hedge, the lower levels of maturity and the short dated hedge maturities and hopefully the return of activity led consumer balances, in turn should help a little with the margin as it develops at the tail end of 2021 and going into 2022. Those benefits are relevant to point out. We will see how that plays into the margin over the course of this year. Again crucially, we will see how many of the current yield curve induced benefits we were able to lock into the hedge and how much activity comes back and how fast. These things are certainly helpful to the margin.

Aman Rakkar
Perfect. Thank you.

Question 5 – Chris Cant, Autonomous
Good afternoon, thanks for taking my questions. The first one is on restructuring. I can't remember a time where we came through full year results and consensus did not need to move higher on next year's restructuring charge. And with you now taking things like R&D spend below the line, what should we see in there as a medium term figure? It has averaged £600 million a year for the last five years, within a fairly tight range. You seem to be pointing to that sort of number for 2021. I am guessing technology R&D is going to continue for the foreseeable future, so presumably we should be pencilling in higher numbers than you see in consensus for the outer years?

The second one is on IFRS17 and in terms of other income as we look out to 2023 and when IFRS17 kicks in. Your recognition of income is going to change and we are going to see a step down in insurance contribution to other income. I appreciate that the economics do not change, but it is going to impact your EPS come 2023. Just curious as to whether you have any sense of the quantum of impact that it may have, given that you are quite Life-heavy and we saw this year that the insurance income is very geared to activity. So quite a lot of day one profit booking and therefore I presume you are quite exposed to the IFRS17 change? Thank you.

William Chalmers
Restructuring, for the full year 2020 was 521. That was there for reasons of an increase in severance, an increase in property and as you saw an increase in technology R&D expenses. Those patterns are pretty much there for severance and for technology R&D at least in Q4, albeit property was down a bit.

What should we be looking at going forward? We have tried to give a sense as to where it is going during the course of 2021 and the primary driver up of that is technology R&D. As we go forward from there, for restructuring, I will not give guidance beyond 2021, but it really does depend upon how we get on with technology R&D as to how much further that has to run and where exactly that goes. We also see continued activity in terms of severance per the FTE comment that I made just a second ago. We also see continued activity in terms of property restructuring consistent with the comment on head office and also branch exposures. And so I would expect those restructuring charges to continue. The degree to which it nudges up or nudges down is primarily going to depend upon how we see that technology R&D developing.

Two points to make beyond that. One is how do we see this restructuring charge and what is in restructuring. Essentially things are in the restructuring charge because they are associated with the cost of exit, e.g. severance in property because they are irregular, e.g. certain elements of the two. But also some of the regulatory and M&A charges that we see and to a degree technology R&D. Because we do not see them as being part of the run rate and when they are part of the run rate then we will duly move them up. What we have tried to do this year and I hope it is helpful, is to improve disclosure around what we are doing. I hope that enables you to look at those charges for what they are and obviously you must treat them in a manner that you see appropriate.

Technology R&D, just a couple of words on that. This is a relatively new area of focus and as the name suggests is on new technology and its potential applications. It has the potential to fundamentally change the customer proposition and our legacy setup with revenue and cost consequences in due course and it cuts across a variety of areas. Customer offering, the enterprise core, the technology platform and architecture, the resilience capability and so forth. It is usually in the Cloud and often with partners, but the key point is and the reason why it is labelled R&D is because it is not yet proven. In 2021, we have a range of measures including a pilot migration. We have a test on various aspects of Cloud to see what the operating offering is and how promising that might be or otherwise. That requires investment in 2021. We will then look towards the end of 2021 about what next steps make sense off the back of that and we will talk to the market about that. Essentially what we are trying to do is to use some of our cost leadership and efficiency to invest in what we think might be the next stage of restructuring for the enterprise. Again customer proposition at one level, cost production at another. We want to invest and see how that develops during the course of 2021 hence the technology R&D label.

IFRS17 Chris is obviously an important point and will gain increasing attention as we go forward. We also have James Hillman on the line from the Insurance team so once I have made a couple of comments I will ask James to add a few. IFRS17 implementation is on the 1 January 2023. Today we have embedded value accounting, which essentially allows us to forward discount new business. Going forward we will have profit recognition over time in line with the contractual service margin model which you will be familiar with. That will mean two things. It will restate some past profit at least, to earn it again based on policies being outstanding. Also, it will remodel the way in which we look at new business going forward to adopt a contractual service margin approach over the life of the product rather than new business or embedded value accounts or upfront.

Overall, as you say, the economics do not change, and that is the most important point. For a growing business, you are going to see two things. One is you are going to see less up front income, but also you are going to see less volatility which hopefully is a good thing. Thirdly, you are also going to see no day one impact on capital. So there is no day one impact on capital, there is less benefit of new business and there is also less volatility. And so over time per the economics being the same, so the earnings are the same.

One other point that you mentioned in your question is that we have seen this year insurance is geared to activity levels. That gearing is because in part of the embedded value accounting. Moving forward when we do not embedded value account under IFRS17, that gearing will be less. I will stop there and James Hillman would you like to add?

James Hillman
I will add one further thing William and Chris. The volatility comes from two places. Clearly, we have volatility in respect of economics. But also where we have assumption changes, which can be significant in any particular year then the impact of those will also under IFRS17 be spread over the lifetime of the business in the same way that the new business value on day one that we recognise now will under IFRS17 be spread over the duration of the business.

So in relation to, as you said, the gearing for the new business and showing that in the 2020 results this year, you will actually see less gearing in respect of new business because by definition we will not be recognising the day one profit on new business going forward once IFRS17 is in place.

Chris Cant
That is helpful, thank you. Just in terms of how you report your insurance business, I understand the benefits around reduced volatility but obviously, you take insurance volatility below the line in any case. So when I am thinking about the other income you report for your insurance division that is £1.3 billion last year and then £2 billion the previous year. That will step down presumably in 2023, the above the line other income from the insurance business will take a step lower and then grow from that level. And if the business encounters another macro blip we will see less volatility. Is that the right way to be thinking about it? What I am trying to get my head around, is the impact of this on 2023 EPS? I think I am right in saying it is negative but on the outside I do not have the visibility on your accounting.

William Chalmers
The volatility is above the line to the extent that it is demographical business volatility for example. It is below the line to the extent that it is market volatility that is out of line with the assumptions encapsulated in the embedded value accounting. There is a distinction there and certainly some of the volatility sources that you and James were just referring to the are consistently always taken above the line. So it is not true to make the distinction as you are making it. In terms of 2023, we will be having in due course a session on IFRS17 and what it means to the overall business. The main characteristic is products that were previously embedded value accounted for up front. So if you wrote the product and took the profitability over the lifetime, will be contractually service margin accounted for going forward. Meaning over the life of the product. So you get the benefits and the rewards with the lifetime earnings of those two products being the same.

Chris Cant
Okay thank you.

Question 6 – Martin Leitgeb, Goldman Sachs
I have one follow-up on the hedge and then one on unsecured please. So on the hedge I wanted to check what is the average duration which you would consider possible under current circumstances given current deposit and equity stuff. Should we think above three years, like the kind of range where it used to be?

Could you comment if year to date you have used or crystallised some of the benefit from the steeping of the yield curve with the hedge, at present 185 and 2.5 in duration. Or has that gone up a little bit given the yield curve?

On unsecured I was wondering how should we think about progression in terms of unsecured balances, should we expect at some point post peak unemployment the unsecured balance growth to accelerate again, is that the right way to think about it? Is there a differentiation between how cards, personal loans and car finance or any other impact say high cost of credit renewal or similar which we will need to factor in? Thank you.

William Chalmers
Thanks Martin. I will answer each of those in turn. I might ask my colleague Israel Santos if he wants to add anything on the unsecured piece in particular. On the hedge, the weighted average life is 2.5 years right now and that represents a pickup over the course of the last quarter. You will have seen from history the range within which we operate, but we generally don't want it to go much below two years as a matter of policy. When rates are better we will take advantage of that and invest. And so when I talked about the £400 million headwind in 2021, there were a couple of reasons why that might be a lesser headwind, not just in 2021 but going beyond. One is because we are able to lock in the benefits of the yield curve across the maturities during 2021.

The second is to your question Martin, we have increased the overall capacity of the hedge and we will be able to invest some of that spare capacity into what is a more favourable yield curve environment. That is another reason and benefit of the dynamic hedge approach that we get and another reason is that we will see how the net interest income develops off the back of the year based upon our investments and the incremental capacity. The capacity is circa 210, the current investment is circa 185 or thereabouts and we will look to move that up in the context of a favourable yield curve environment.

On unsecured balance growth. Overall we think that unsecured balances are a function of the macroeconomic environment that we have got. Clearly lockdown has had a significant role in terms of unsecured balances over the course of 2020 and indeed it will continue to have a role in the course of January and February of 2021 where muted activity in turn leads to lesser activity in terms of unsecured balances. Now that development over the course of the year is very much a function of how the Government chooses to ease up or otherwise on lockdown. Overall, I would expect as the country emerges from lockdown for activity levels to pick up and for unsecured balances to pick up. Until it does there is continued pressure on unsecured balances. And so do we have a pivot around the half year where pressure on unsecured balances starts to turn around and go in the other direction? It is possible Martin. It will depend upon how the lockdown and macro economy goes. There is no doubt though that there is a positive correlation between levels of activity and unsecured balances.

Israel would you like to add at all to that?

Israel Santos
Thanks William. My only add and Martin alluded to the different products, is based on how the first lockdown happened and the recovery after the first lockdown and what we are seeing now is recovery in the car space is a little bit faster than you would see in the credit card space. The only reason I say that is it takes time for customers to build up their balances in terms of the card book. You might see that the increase in activity level helps us from an OOI point of view. But the time it will take for balances to recuperate and therefore contribute more positively to an NII, might be a little bit longer than what you might see in Black Horse for example, where we are seeing recovery a little bit faster. Similarly, in loans you are probably seeing recovery a little bit faster than what we have had in cards.

Martin Leitgeb
Thank you.

Question 7 – Gary Greenwood, Shore Capital
Hi thanks for taking my questions. So the first one is revenue. So in 2019 you had about £17 billion of revenue, that dropped down to just over £14 billion last year and if I look at consensus at pre-results it didn't really have much of a change in revenue over the next couple of years. Now I know your guidance for 2021 but I am presuming further out you

are probably a bit more optimistic than the consensus especially given the changing yield curve environment. I am just trying to think how long would it take to grind back to where you were in 2019 if the environment plays out as you expect?

Then the second question is on capital. If I take account of the various regulatory movements, software intangibles, IFRS9 transitional relief. Then take account of the pension payments. You are probably still going to end the year with quite a significant excess relative to your target level, should we think about that excess coming back to shareholders in one lump sum or do you spread it over a number of years? Also, what is your preference for buybacks versus dividends or is that just a function of where the share price is at any given point in time?

William Chalmers
Thanks Gary. On the first of the two questions around revenues. It is obviously an important area to us. We firmly believe getting the business back into growth trajectory in revenues in its core franchise is absolutely key for the success of the business. Overall, we have given you hopefully enough guidance to figure out how 2021 might look. Beyond that as you know we are not giving guidance today. We see it as a function of two or three main lines that are relevant. First of all the yield curve being one of them and that will clearly drive the structural hedge. But also, the levels of activity that we see, in the mortgage market, in the unsecured market and so forth. That has been pretty benign over the course of Q4 and continues to be pretty benign in what we see today with respect to mortgage assets and the unsecured picture as we just discussed. The overall net interest income line is a function not just of the yield curve and how that permeates the structural hedge and the benefits that we get there, but also is a function of AIEAs, which we have portrayed as being flat to modestly up in the course of 2021. In the years thereafter, if we see an economic pickup in recovery then I would hope that levels of assets, both secured and unsecured, continue to benefit from that going forward.

The rising rate environment benefits the structural hedge, potentially benefits liability margins interfacing with an increase of activity, which benefits retail secured and unsecured assets. One would hope that over time it benefits commercial assets and so gets a momentum in AIEAs, which based upon attractive prices and margins in turn should develop into net interest income over time.

On other operating income and with a sense as to activity gearing. Likewise in a recovering economy I would expect that to continue to phase through. Whether it is new business within the insurance area, or things like interchange and other activities within the retail area. Whether it is our payment business or our markets business within the commercial area. These businesses should build in the context of a macro recovery. Added to which is the benefit of the investments that we have been making in the other income area. Again, one could cut across the three businesses that we have laid out in the strategic 2021 piece. I would expect the organic benefits of a resumption in activity to be supplemented by the organic benefits of ongoing investments in the other income line and that too would build income over the time frame. I won't put a number on it but hopefully it gives you some sense that we would expect momentum in the revenue line to build in gradually as the economy recovers in both net interest income and in other income.

The capital position for 2021, we have hopefully given some sense in terms of the overall guidance number one, but also in our view on capital generation being driven in part by profitability and in part by IFRS9 transitionals as those run off during the course of the year. There is also the software piece, which to all intents and purposes seems to us that the PRA is going to reverse over the course of the year so one should take account of that as well. Nonetheless, without adding to guidance in any way the capital position does feel very solid. Even in the context of our RoTE and IFRS9 transitionals as guided to and in the context of software as I just said, that still feels like a pretty solid capital position. When we get to year end, how we are going deal with that excess capital? First of all, let us just make sure that my comments are right around the strength of the capital position and excess position, but I would expect them to be. The Board at that point will look at the macros, number one, the regulatory position, number two, and the expected trajectory of the capital position over the course of 2022 and beyond, number three. Based upon that we will make a determination not just on the ordinary dividend but also what to do with respect to any excess capital at that time.

Those three elements and no doubt others too, but those three elements, Gary, give you a sense as to what the Board will be looking at in terms of this overall distribution strategy at that time.

Then buybacks versus dividends. First of all, we absolutely get the importance of capital distribution to shareholders. We are an income stock and that point is not lost on the Board. That is what is behind the progressive and sustainable dividend and the desire to move to the progressive and stable dividend over the course of this year. We will start off with interims, we will then get the ordinary dividends at the end of the year. We would aim to re-establish that ordinary dividend in line with the progressive and stable quality at a level higher than the 0.57 pence per share, which let us not forget is a regulatory determined level. That 0.57 pence per share is not a number of our choosing. We will look to re-instate the dividend policy as said. Beyond that the attraction of buybacks in the context of a stock that is trading below book are apparent. The Group has used buybacks before. At current context, it may be the case that a buyback is even more attractive given where we are trading, but that will be a decision for the Board at the end of the year.

Gary Greenwood
That is all very clear, thank you very much.

Question 8 – Raul Sinha, JP Morgan
Hi William, thanks very much for doing this call. I have got a couple of follow-ups if I may. The first one is on tax. I was wondering if you might be able to give us some sensitivity around any potential tax increase on your DTA position. I guess we can see what happened earlier last year when tax rates were held at 19%. Should we take that as a proxy?

Related to that from the RoTE guidance, have you made an assumption around the tax yet or are you assuming that it remains broadly stable?

Then the second question is on the capital allocated to the Group centre, balances have gone up in 2020. I was wondering if you might share some thoughts on how you plan to manage this given the size in a Group context going forward and what might be any significant moving parts that we should be aware of? Thank you.

William Chalmers
Thanks Raul. In terms of tax roughly speaking, I think you are right and we saw the commitment back to the 19 per cent in the course of the year earlier on. We saw the movement of DTA off the back of that and I think you are right, that is pretty indicative of the overall sensitivity. If we see another tax rise you might see a similar change to DTA off the back of that.

In terms of the RoTE assumption, the tax rate is the rate that we have in application right now. That is to say the guidance that is given is consistent with today's tax rate.

Finally, capital allocation to the Group centre. I do not have terribly much to say on that at the moment other than to say that as a matter of management philosophy we would look carefully at capital allocations in the Group centre just as we would look carefully at any allocations in the Group centre. It is not our intention to build up the Group centre in any sense. It is our intention to ensure the divisions are managed in a way that is consistent with their generation of revenue, their consumption of cost and capital. I probably won't go much further than that Raul, but that is the overall philosophy.

Raul Sinha
Okay, thank you.

Question 9 – Guy Stebbings, Exane BNP
Hi good afternoon William. The first one just on recent rates in business and how to think about it more broadly. Very helpful with the structural hedge. But as yet, we haven't really seen much pricing movements at all in the mortgage market. So based off where the mortgage spreads are, one could deduce that, that fully offsets the hedge benefit. I am just wondering what your perspective is on that, is it just far too soon to really see much pricing action? Do we need to wait three, four weeks before we can think about how the market is responding and what that means for the overall profitability?

And the second question is just on the structural hedge again. I am struggling a little bit with the concept of increased hedge notional capacity which I appreciate you are not alone in reflecting on the recent deposit inflows and what that might allow you to do. A lot of that growth in capacity comes from inflows during the crisis, which we have never ever been through before with obviously deposit rates from a customer perspective not very attractive. There is not historical precedent on whether those deposits are sticky and whether they are non rate sensitive as we go forward. How much conviction do you have and how much modelling can you really do to have confidence you don't over hedge as you look forward? Thanks.

William Chalmers
Thanks Guy, both fair questions. On the rate movement first of all, we have not seen much movement in terms of the mortgage pricing so far. It is worth making a couple of points. One is we had a very strong performance in the second half of 2020, in particular in the fourth quarter of 2020 where we put on £6.7 billion of balances in the open book. All that on very attractive spreads. We had total completed spreads of around 190 during that time which is considerably higher than the pricing of maturities. So the replacement rate was considerably higher and that completion margin allows very favourable return on the balances and the capital that is tied up. That is the case so far and to your question, we have seen a little bit of pull back over the course of the first couple of months of this year but both volumes and pricing remain very attractive. The pull back we have seen has been

significantly a large feature because swaps pricing has been going up and pricing has not necessarily been keeping pace with that as much. So there has been a little bit of compression on that front. But pricing remains very attractive and pricing compression so far, the type I just described remains quite limited. We have to see how that plays out over the course of the year. That will be a function of demand and will also be a function of competitive behaviour. With that, I note that many banks are trying to get their levels of profitability back to appropriate levels and maybe that will influence their behaviour, but we just have to see.

There are some structural factors behind demand, around people moving houses to places that are more appropriate or suitable for working from home. The stamp duty extension will help, albeit there has to be a time frame put on that. But those two benefits are structural and can survive the immediate cycle. We had this situation before and I do think every time you see a bit of a tick up in the yield curve there is a corresponding impact on mortgage pricing. I also think the other way around is true, and I have argued many times that when the yield curve flattens I think mortgage pricing goes up. So I do think there is a quid pro quo there. But the critical point is, so far and I expect looking forward, but certainly so far, this is for the net benefit of our margin and of our net interest income. There is no doubt that the benefit of the yield curve is outweighing what limited compression in mortgage pricing we have seen. That is an important point. And as it stands today so far there is no doubt that these interest rate moves, even netting off the mortgage pricing will be of a benefit to us from an interest margin and from a net interest income point of view.

Second point, in terms of hedge capacity. That is a very fair challenge and one that we have obviously debated a lot internally. I would make a couple of points to it. One, as you saw we increased our hedge capacity by £25 billion in 2020. That £25 billion was the source from two primary places. One is the increase in deposits and the other is the change in the nature of many of the deposits particularly in the commercial area. So in commercial £11 billion of that £25 billion we have effectively changed the managed rate deposits from their previous form, which in term makes them eligible for structural hedge. It makes them eligible for the structural hedge simply because they are therefore slightly more under our control, and therefore more appropriate for longer term structural hedges. So only £14 billion of the increase in £25 billion was actually due to growth in deposits. And a significant part of that was making up for lags in increased hedge capacity off the back of 2019 balances rather than the £40 billion increase in deposits that we saw during 2020. So a relatively small proportion of the increase in hedge capacity had anything to do with 2020's increase in deposits. That is why Guy we feel very comfortable about not just increasing the hedge capacity, but also investing into it, in order to take advantage of the current yield curve. The hedge capacity even if we get a rundown in deposits off the back of that £40 billion that we saw in 2020 that is not going to drive a change in the hedge capacity.

The only other point I would add to that is that we shouldn't see the run-off in deposits as a threat for two reasons. One is because that run-off in deposits is going to be correlated with an increase in activity. So what you lose with one hand you will gain with another. And two, we see those deposits to the extent that the rate environment remains low as an opportunity to enhance the wealth performance of the business and to offer our customers frankly better propositions. We don't see those deposits running off as a threat, we see it as an opportunity.

Guy Stebbings
Okay thanks that is helpful.

Question 10 – Aman Rakkar
Thanks guys, thanks for letting me ask one additional question. Just coming back to the point on tax. This might be a bit fanciful, but I wondered, have you been engaged at all with the Government around the appropriateness of the bank surcharge tax. Have you had any conversations to that effect as to whether there may be some offset that we should think about?

William Chalmers
I won't comment specifically on conversations as such. But I think it is safe to say that we talk to the Government about policy matters generally and tax within that is certainly one of them. What weight our comments have in the minds of the Government I think is for them to call rather than us. But certainly policy matters are of interest to us and we do engage with the Government.

Aman Rakker
Thank you very much.

Question 11 – Ed Firth, KBW
Good afternoon everybody, thanks so much for taking an extra question. My first question was if one looks at this downturn or where we are so far, I guess one of the absolute standouts has been the extraordinary performance of credit or rather lack of any losses at all or any deterioration. And I still have two questions. One is how much of that do you think is due to your better modelling and the better systems you have these days for lending? And how much of that is due to Government initiatives and the support of furlough schemes etc?

The second related to that is assuming that this continues now and we basically have a credit free downturn this time, how does that influence you when you think about your strategy going forward in terms of pricing or in terms of which markets you want to be in and how much lending you want to do for example?

William Chalmers
A couple of points I will make to that. In so far as the first point of your question I think is exactly right. We have seen so far a very benign, if that is the right word in these circumstances, observed credit experience. Now you will have seen that in our 2020 Q4 charge and also you saw it to a degree in the 2020 Q3 charge as well. But you particularly saw it in the context of the Q4 charge, with £128 million charge but off the back of a significant suppression of releases. Now how much of that is due to investment in Government programmes? We believe that the credit book is very sound, that will not surprise you to hear me say that. But when we look at the credit book, whether it is in relation to the secured part of the book, whether it is in relation to the retail part of the book, the commercial part of the book, CRE, the cards part of the book. When we look across the balance sheet we do believe the asset quality is very strong and believe that gives us a degree of resilience to a downturn whatever the origin.

Now having said that, it is also the case that the Government and the payment holidays that we and other banks have introduced have both had a role to play in terms of softening the economic downturn significantly. And so how do we look at that? One way to look at this is to look at the IFRS9 modelling that we have done, but then also look at the management judgement overlay that we have put on top of that. And if you look at our Covid-driven management judgement overlays you will find essentially there are broadly speaking two sources of them. One is a management judgement overlay that basically takes the observed credit performance and say actually there is some suppression of arrears and defaults because of Government furlough programmes and payment holidays, and so we think that is underestimating the true level of arrears and defaults that might otherwise happen absent of those, and will happen as those are lifted. And so we add on the management judgement in addition to the IFRS9 models outcome. So that is point one.

Point two is that we also add on top of that an uncertainty overlay which is essentially saying if our input assumptions into the IFRS9 outcome are wrong then we have taken a £400 million overlay to accommodate the fact that those assumptions may go off in a different direction. Whether that is virus mutation, a slowdown in vaccines or an earlier than expected lifting of Government policy support. If those assumptions are wrong we want to be covered and so we have taken a £400 million overlay to cover that assumption inaccuracy. So that's the second sort of overlay. Roughly speaking it is about £450 million for the suppression point and it is about £400 million for the uncertainty overlay. In total, Covid-related judgements is about £888 million. Maybe a good way of answering your question, to what extent is this a function of our superior modelling versus the function of Government and other support? We have taken a separate £888 million overlay as a management judgement to accommodate that uncertainty.

Total impact on strategy, if it does turn out to be a credit trouble free recovery, the first point I would make there is that essentially what the Government is trying to do is to bridge the chasm, going into this everybody expected a sharp downturn and then a sharp recovery up the other end. The Government is effectively trying to put a bridge across those two points and therefore to make the chasm either non-existent or certainly a lot higher or less low than it would otherwise be. We have to see whether that bridge extends far enough to get to the other side and I guess on Wednesday with the budget we will get a bit more insight into that. But there is a chance that the bridge does a pretty effective job of making that chasm not as deep as it might otherwise be.

What effect will that have on us? The first effect I would call out is capital. If that is the case then some of those overlays that I was just talking about, the management judgement will not be necessary. Some of the IFRS9 transitionals will not get used up as assets move from stage one and stage two into stage three because they will not actually move into stage three because that chasm has been bridged. Our economic assumptions end up being better as a result of outcomes for overlays and transitionals end up being better too. So the first point is if that is the case we are going to have more capital than we expected.

The second point, will it drive strategic change? I am less sure of that Ed. I do think it will make us more confident about the recovery. But whether that is strategic or cyclical I think is a debate. I would also add that this is a very particular situation, with a pandemic where the Government chose to take extraordinary measures. I am not sure that we will rely upon that every time there is a downturn.

Ed Firth
Okay. That is very helpful, thank you.

William Chalmers
We have reached just past the hour so I will just say thank you very much indeed to everybody attending. Thanks very much indeed for your questions. I look forward to continuing the dialogue in the coming days and weeks and wish everybody a good day.

END

FORWARD LOOKING STATEMENTS

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