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

Thursday 30 July 2020 – 9.30am

LBG HOSTS:
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António Horta-Osório
Good morning and thank you for joining our 2020 half year results presentation. It is a shame that we can't gather in person today, but I am pleased that we are still able to hold this virtual event. I will give an overview of our response to the coronavirus crisis and how our strategic transformation to date has positioned the Group well to face the evolving environment. I will then hand over to William to run through the financials and we will have time for questions at the end.

Before I start, I would like to again thank my colleagues from all across the Group. They have maintained their exemplary dedication and professionalism in the face of significant personal and professional challenges, whilst remaining absolutely focused on supporting our customers.

As you will have seen, I recently announced my intention to step down as Group Chief Executive by the end of June next year. Until then I remain wholly focused on my responsibilities and I am committed to delivering the remainder of GSR3. I will present the full year results in February while my successor will update the market on the next stage of the Group's strategy in due course.

I will turn first to our response to the crisis on slide 2. We are now several months into the pandemic, and while progress has been made on reducing the immediate threat of the virus within the UK, the crisis is still having a significant impact on people and businesses across the UK. As a result, our core purpose of Helping Britain Prosper and our strategic aim of being the best bank for customers, colleagues and shareholders are now more important than ever before.

I am proud to say that we have offered unwavering support to our customers over this period and have been quick to respond to their evolving needs, including through the facilitation of more than £9 billion of government backed lending for businesses and granting more than 1.1 million payment holidays for our retail customers.

The efforts of our colleagues to enable this support have been immense and in March we enhanced our support for colleagues by providing job security during the most uncertain of times and also made a range of awards to our frontline colleagues in June.

In line with the easing of some lockdown restrictions, we have started to see the UK economy return to growth with some signs of recovery in the Group's core markets. This recovery has largely been driven by consumers as opposed to the slower recovery we are seeing in commercial sectors.

As a Group which has around 75 per cent of its lending to prime UK retail customers, we are well positioned to benefit from this recovery. Having said that, we are conscious that longer term uncertainty over the pace and extent of the UK's economic recovery remains and we have seen a deterioration in the outlook since we last presented to you in April. This has had a meaningful impact on our impairment charge in the second quarter, as William will explain shortly.

Despite this uncertainty, the Group is well positioned to meet future challenges and seize further opportunities, benefitting from our existing competitive advantages, our positioning, ongoing investment in digital and our overall strategic transformation.

We were the first bank to recognise the power of digital by creating a standalone division across the whole bank in 2013, with an executive director reporting into the Chief Executive. Our digital offering continues to go from strength to strength, with customer trends towards using this channel accelerating and further recognition for our market leading digital offering.

From a financial perspective, the actions that we have taken over the last nine years to strengthen our balance sheet, such as the sale of non-core assets, the removal of net wholesale debt and a more even matching of our loans and deposits, position us well to weather the inevitable impacts of the crisis.

Our strong balance sheet and capital position will enable us to continue supporting customers in times of need, while also remaining focused on the future and reinforcing our competitive advantages.

Turning to our strategic progress on slide 3. While the crisis has required decisive action in response to short term challenges, we are now approaching the end of GSR3 and remain committed to delivering against our longer term ambitions. I would like to highlight some of the benefits of our investment which have been evidenced during the last few months.

We remain the largest digital bank in the UK and have now reached 17 million digitally active users, and this growth is supported by record levels of customer satisfaction, even in a period of increased demand.

Our digital NPS increased by 8 per cent in the first half of the year and both this and our mobile app NPS reached all-time high scores. Despite this, our multi-channel model has remained invaluable for those customers who require face to face interaction, and around 90 per cent of our branches have remained open through the lockdown.

We also remain committed to delivering cost efficiencies and continually creating capacity to invest in the business. This level of investment has enabled us to respond quickly to new challenges, such as using robotics to process around 98 per cent of Bounce Back Loan applications with money credited into customers' accounts mostly within 24 hours, and significantly improving colleague capacity when it was needed most.

Finally, we continue to serve a wider range of our customers' financial needs than ever before. We have delivered significant market share gains in a number of our Insurance and Wealth business lines since we updated you on our progress this time last year.

We continue to see significant new opportunities in Financial Planning and Retirement, with the significant increase in customer deposits in the first half providing opportunities to further support these customers with their varying financial needs. Our ambitious wealth joint venture, Schroder's Personal Wealth, also continues to make good progress. In the first half of the year Schroder's Personal Wealth launched eleven regional hub offices that support its decentralised model, allowing clients to receive a more personal and local experience. The business retains the ambition of becoming a top three financial planning business by the end of 2023.

While the crisis has resulted in some delays to the roll out of our unique Single Customer View capability due to the deferral of some discretionary strategic spend, we have added another 1 million customers in the first half and this will continue to grow. We continue to see our ability to offer our customers all of their financial needs in one place as a distinct competitive advantage.

Moving to slide 4 and looking beyond GSR3, the organisation is mindful of the longer-term impacts of the crisis and is well positioned to respond to them. We are starting to see the emergence of new trends and the acceleration of others, as you can see on the slide. While some of these are likely to prove challenging for the whole of our industry, others represent great opportunities for a business that is as engaged and customer focused as ours.

As a result of our long-run transformation, the Group is built upon strong foundations which will support our response. These include our strong financial position; our unique business model, which harnesses the strengths of multi-channel and multi-brand; a willingness to adopt new ways of working through the use of technology and greater collaboration with external technology partners; and a truly differentiated franchise. I have spoken about our virtuous circle in the past and continue to see that as a cornerstone of our competitive positioning.

These foundations leave the Group well equipped to provide a compelling offering for our customers and colleagues in the future, while also enabling long-term superior and sustainable returns.

While I will not be leading the next phase of our development, the timing of the arrival of the new Chairman and of my retirement will ensure no loss in momentum in driving forward our strategic transformation, to which the Board is fully committed.

Turning now to the Group's financial performance on slide 5. The Group's financial performance in the first half of 2020 has been impacted by the low rate environment, as well as depressed customer activity and a significant deterioration in the economic outlook.

We have maintained our rigorous approach to cost management and total costs are down 4 per cent, including BAU costs down 6 per cent. However, despite the continued cost reduction, pre-provision operating profit is down 26 per cent as a result of the challenging revenue environment.

We took an impairment charge of £3.8 billion in the first half, largely due to the worsening of our forward-looking economic assumptions and this is despite our current experience, which remains relatively benign.

Statutory profit after tax of only £19 million has clearly been significantly impacted by this impairment charge.

The Group's balance sheet remains very strong and CET1 at 14.6 per cent, on a transitional basis, is very comfortably above our capital requirements.

As I have mentioned, the economy has deteriorated since Q1 and, although we are seeing some recent signs of recovery, uncertainty remains.

As you can see on slide 6, customer spending fell sharply in March and April but has gradually picked-up and is now broadly in line with pre-crisis levels. Similarly, loan demand fell at the start of the lockdown period and whilst personal loan applications remain at about 70 per cent of normalised levels, we have seen more of a recovery in mortgages and motor finance, which have reached pre-Covid levels.

The UK consumer is being prudent, and rightly so. William will go through the balance sheet in detail shortly, but we have seen customers paying-down unsecured debt while building savings balances. All of this is within an environment of low rates, low inflation and only modestly falling house prices.

The recovery has been slower in commercial sectors, particularly in the key impacted sectors such as hotels, leisure and transport. Our SME and Business Banking clients have seen credit turnover increasing since the low point in May, although in total they remain 10 per cent below pre-crisis levels while the impacted sectors are still 27 per cent below.

I will now turn to slide 7 to look at how we are helping Britain recover and how supporting our key stakeholders is clearly in the best interests of sustainable shareholder value creation.

We have an opportunity to build a stronger bank whilst supporting a resilient economy with a more sustainable future. We will do this by working with our key stakeholders in order to develop household financial resilience and help businesses recover from the challenging operating environment, while also helping to finance the UK's green recovery.

We will also accelerate the work already underway to transform our ways of working, with a strong focus on talent and diversity, and thereby retain and attract the best talent within the Group.

All of these actions, and many more, will mean that we are able to help Britain recover whilst simultaneously building a stronger bank. This is clearly aligned with the best interests of the Group and our shareholders.

In conclusion going to slide 8, the Group has strong foundations and, as you have heard me say many times before, our unique competitive strengths position the Group well for the future.

Our business model, superior efficiency and track record of consistent and sustainable delivery will continue to drive ever-lower costs with increased and sustained investment in the business and a better customer experience as a continuous outcome. It is this virtuous circle, that you have heard me talk about before, which means that we are well positioned to deliver long term superior and sustainable returns.

Our updated 2020 guidance reflects the Group's proactive response to the challenging economic environment and is based on our current macroeconomic assumptions.

Activity in the Group's core markets has begun to recover, but the impact of lower rates and economic fragility will continue for at least the rest of the year.

We therefore expect the margin in the second half to be broadly stable on the Q2 level at circa 240 basis points, resulting in a full year margin of circa 250 basis points, operating costs to be below £7.6 billion and impairment to be between £4.5 and £5.5 billion. We expect risk-weighted assets in 2020 to be flat to modestly up versus H1.

While the economic outlook remains highly uncertain, the Group's financial strength and business model will ensure that we can continue to support our customers and the wider UK economy through the crisis and beyond.

This is fully aligned with the Group's long term strategic goals and in the best interests of our shareholders.

I will now hand over to William who will run through the financials in detail.

William Chalmers
Thank you António, and good morning everyone. I am going to give an overview of the Group's financial performance in the first half of this year. I will also spend some time discussing our balance sheet strength, approach to IFRS 9 and the impairment charge that we took in Q2. As usual, we will then open up for Q&A at the end.

Turning first to slide 10, with a summary of the financials. As you've heard, the Group's financial performance has been impacted by a challenging revenue environment and the significant deterioration in the economic outlook for the quarter.

Net income at £7.4 billion is down 16 per cent, driven by a lower margin of 259 basis points on stable average interest earning assets and other income of £2.5 billion.

As António mentioned, our focus on costs remains strong and the 4 per cent reduction in operating costs includes 6 per cent lower BAU costs. The cost:income ratio meanwhile has been impacted by the pressure we see on the income line.

Moving down the P&L, pre-provision operating profit of £3.5 billion is down 26 per cent. This is lower than we would like, but it still gives the Group significant loss-absorbing capacity.

The impairment charge of £3.8 billion in the half reflects our prudent reserving based upon the updated economic outlook. We will discuss this in more detail shortly. Despite the significant impact that the impairment charge has had on profits and returns in the first half, TNAV remains strong at 51.6 pence. Our CET1 ratio has increased by 81 basis points to 14.6 per cent including transitionals, or 13.4 per cent excluding transitionals. Both levels are comfortably ahead of our reduced regulatory requirements of around 11 per cent.

We will look at the individual lines in more detail shortly, but first let's look at customer activity on slide 11.

As António mentioned, retail customers are being cautious on borrowing and are building savings balances. This is clearly positive from a risk perspective, if not for our revenues in the current rates environment. Nonetheless, the deposit inflows demonstrate the strength of our trusted brands in what is an uncertain environment.

Our SME clients have increased borrowings, largely through the Government-backed schemes, although we estimate around two thirds of those balances currently remain on deposit.

Large corporate and financial institutions clients meanwhile have reduced their borrowings in Q2, largely through repaying some of the £8 billion in RCFs which were drawn in March. We have also seen a reduction in deposits in Large Corporates as we have repriced in this area.

Looking forward, I expect unsecured lending to continue to reduce although at a slower rate than we have seen in H1. I also expect the open mortgage book to grow modestly, in line with market growth. Commercial Banking meanwhile will continue to focus on SME lending, while I expect Large Corporate lending to fall slightly as clients are now accessing capital markets.

The net of all of this is that we expect average interest-earning assets to be broadly stable on H1's level through the second half.

With that said, I will now turn to net interest income in a bit more detail on slide 12.

The Q2 net interest margin of 240 basis points is down 39 basis points in the quarter, in line with guidance given at Q1. Also as expected, the rate impact of 21 basis points is around half of the reduction, with the rest due to product mix and the actions we have taken to support customers.

Looking forward on the margin, I would expect the rate impact to continue into the second half of the year as the structural hedge rolls over into a lower rate environment. Furthermore, while the mix impacts should gradually reverse as activity normalises, we expect the effect of lower balances in our higher margin areas to persist into H2, reflecting economic activity and customer behaviour.

Offsetting this somewhat, there should be some benefit to come in Q3 from tailwinds such as the end of free overdraft periods and deposit repricing.

In this context and as mentioned earlier, average interest-earning assets should be broadly stable on H1 through the second half.

So, based on all of this, and as António mentioned, we expect the margin to remain essentially stable at the Q2 level, throughout the rest of this year and this in turn means we expect the full year margin to be around 250 basis points.

Now turning to asset margins on slide 13. Individual asset margins have remained robust in H1 while overall NII has been impacted by the reduction in higher margin activity.

The consumer finance margin for the period is 6.81 per cent, although lower in Q2. This has been particularly impacted by lower cards balances compared to other products within consumer finance.

Meanwhile, the mortgage markets is now recovering to pre-crisis levels.

Mortgage book margins remain resilient, supported by a new business margin of around 1.7 per cent, retention of around 70 per cent of our customers at the end of their fixed rate term and a slight reduction in the SVR attrition rate to around 12 per cent.

The mortgage book margin has also benefitted in the half by a couple of basis points from temporary timing differences associated with base rate movements.

Commercial Banking has seen an increase in balances in the first half given the take-up of Government schemes. The Commercial margin is up slightly due to the ongoing optimisation work, while the low risk new Government lending is priced below the wider SME book.

Turning to the other side of the balance sheet. Slide 14 on deposits.

As mentioned, we saw a significant increase in customer deposits in the first half, up £29 billion on year end and ahead of the market. This in turn reflects the strength of our brands in uncertain times.

We have seen a 2 per cent increase in retail current account customer numbers in recent periods to 17.2 million, while those customers are now holding higher balances, on average £1,000 per customer more.

Some of this will inevitably unwind as customers start spending more, but nonetheless we expect overall balances to stabilise at higher levels.

Indeed, the Group remains well positioned to address these customers' broader financial needs within its portfolio of trusted brands.

It is worth noting here that although the full benefit of the pricing changes made after the base rate cuts will come through in Q3, beyond this we will have limited room to further reprice deposits.

Now let's turn to the structural hedge on slide 15.

Our hedgeable capacity has increased slightly to £190 billion. Within this, the hedge notional balance of £180 billion is up slightly on year end. Given the significant increase in deposits this half, as shown on the previous slide, there may ultimately be more capacity.

The Group benefitted from hedge earnings of £0.6 billion or 0.7 per cent over average LIBOR in H1. Subject to rates, hedge earnings will likely reduce in H2 as the £15 billion of maturities that we expect in the second half are reinvested at lower levels. Beyond that, the hedge has a pretty straight line maturity profile.

Now looking at other income on slide 16. OOI of £2.5 billion for the first half is down 22 per cent year on year. This is due to a slowdown across our key markets, as well as the one-off items in Vocalink and Insurance that we saw last year. We also had £135 million of gilt gains in H1 which I do not expect to repeat in the second half and which were almost entirely offset by the £110 million revaluation adjustment in Lloyds Development Capital, again in H1 of this year.

Going the other way, Q2 included a £90 million benefit relating to an illiquidity premium methodology change within Insurance and this is not going to repeat in H2.

Looking forward, we expect a charge in H2 within Insurance, relating to the asset management market review. We will also consider our persistency and longevity assumptions in the second half, the former focusing on the possible impact of higher unemployment levels.

In retail, ongoing lower levels of activity across products will likely have a marginal negative effect in H2.

Overall, other income is likely to be tough in the short term although we are now getting towards a base level. We are investing in growth areas such as our Financial Planning and Retirement proposition as António mentioned within the Insurance and Wealth division and also in our payments area. In addition, we expect activity to pick up in 2021.

Now moving on to costs, on slide 17. You have heard many times about our relentless focus on costs. Lower compensation has contributed in H1 and will continue into H2, although to be clear, we have also continued to realise sustainable cost savings.

It is this track record that enables us to enhance our operating cost guidance for 2020, for less than £7.6 billion.

We are finding that while coronavirus has increased some cost areas, the lockdown has also accelerated certain more benign trends around the use of technology, home working, travel, and cross-training colleagues. We will be adopting these learnings and exploring opportunities for longer term cost savings in due course.

Moving on to investment. In response to the challenging revenue environment, we have carefully managed discretionary investment spend down by 15 per cent, as you can see on slide 18.

We have reduced investment in our branch transformation, as well as third party consultancy spend, whilst prioritising investment in digital and technology projects. Digital spend remains around 80 per cent of the Group's total investment commitment, important given digital development is so vital to the long term success of our Group. We will continue to invest through the cycle in the strength of the business.

I will now spend some time looking at the impairment charge in the second quarter, starting on slide 19. As you can see, the charge in H1 of £3.8 billion includes £2.4 billion in Q2, of which £1.8 billion reflects a modelled charge for the significant deterioration in the economic outlook. Including the Q1 impact, the total forward-looking economic impact in the half is £2.6 billion, almost 70 per cent of the H1 impairment charge.

Excluding the updated economic outlook, divisional charges have increased by £22 million in Retail and £141 million in Commercial from H1 2019, the latter from a very low base.

The coronavirus impacted restructuring cases reflect clients where the pandemic has directly hampered their recovery strategy. The charge of £432 million predominantly reflects historic debt on two individual names.

In sum, the AQR for the first half of year is 173 basis points. Within this, the charge, pre-economic assumption changes, is equivalent to 36 basis points.

Uncertainty, of course, remains and the final impairment charge will depend upon the severity and duration of the shock. However, based on our current prudent economic assumptions, I would expect the full year impairment charge to be between £4.5 and £5.5 billion. This gives an idea of the front-loading of the charge under IFRS 9 requirements and as said, assumes current macro forecasts don't change.

Let's now look at the updated economic assumptions on slide 20.

The main drivers of impairment charges for us are GDP, unemployment and house prices. Our base case assumes GDP down 10 per cent in 2020 and unemployment at around 7 per cent in 2020 and 2021. Peak unemployment in our base case is 9 per cent in Q4 2020.

We have also adjusted our Severe scenario, to which we give a 10 per cent weighting, to add prudent overlays including, for example, peak unemployment of 12.5 per cent in Q2 2021, GDP down 17.2 per cent in 2020 and HPI down 29 per cent over 3 years. This is in response to these unprecedented times and a desire to properly recognise this risk.

The overall impact of our multiple economic scenarios is a currently provided ECL of £7.2 billion, a pick-up of £0.5 billion on our base case and an increase of £3.1 billion since December 2019.

Now turning to coverage levels on slide 21. The increase in ECL provisions across the business lines has naturally resulted in higher coverage levels across Stages and across products.

The £3.1 billion increase in the ECL in the half and £7.2 billion total ECL give additional balance sheet resilience and buffers to absorb losses as they may arise.

Coverage has increased to 1.4 per cent of total lending and almost 30 per cent of Stage 3 assets. This includes 6.3 per cent coverage of the Cards portfolio and 44 per cent of Cards Stage 3 balances.

It is worth noting that the Cards business, as mentioned, employs a proactive charge off policy at 4 months in arrears. If we instead adopted a slower approach to charging off, let's say an additional 12 months, our Stage 3 Cards would have coverage of around 70 per cent and the overall Cards book of almost 9 per cent.

Turning to slide 22.

The Group has a very robust balance sheet which benefits from a prudent approach to lending and around 85 per cent of lending secured.

Meanwhile we have more than 75 per cent of Group lending within our prime retail portfolio. The remaining 25 per cent of the loan book is within Commercial Banking, of which 40 per cent is to SMEs and Mid Corporates, which in turn is over 80 per cent secured.

This gives us a high level of confidence that our balance sheet is robust and our customer mix is appropriate going into a period of uncertainty.

We have also halved risk-weighted assets over the last decade, meaning we entered this period with significantly lower RWAs than during the last financial crisis.

Let's now look at each of the main portfolios, starting with mortgages on slide 23.

As you know, two thirds of the Group's lending is in high quality UK mortgages, with an average LTV of 44 per cent and around 90 per cent of the book having an LTV below 80 per cent.

The portfolio is performing well, including the 2006 to 2008 heritage book. This now has LTVs in line with the wider portfolio and is continuing to run down at about 12 per cent each year.

Stage 2 mortgage assets have increased by £17.2 billion in the half, to £44 billion. However, it is important to note that £37.6 billion, or over 85 per cent of Stage 2 lending, is up to date and has largely migrated due to the forward-looking economic assumptions.

The movement in Stage 2 and our modelling of PDs capture the risks inherent in the current level of payment holidays. We have granted 472 thousand mortgage holidays during the crisis and of these, 193 thousand have reached the end of their holiday. 72 per cent of which have resumed paying, 23 per cent have sought an extension and 5 per cent have entered into arrears.

We have increased coverage on our Stage 2 portfolio to 2.1 per cent overall, including 1.5 per cent on the up to date Stage 2 assets.

Now looking at our consumer finance portfolio on slide 24.

As you have heard many times, our high quality growth and prudent risk appetite are hallmarks of the Cards book. Customer credit card spend is still down circa 20 per cent compared to February and customers, including higher risk customers, have deleveraged over the last few months.

Cards assets within Stage 2 have increased to £2.1 billion, 13 per cent of the book, largely due to forward-looking economic assumptions. Indeed, 96 per cent of Stage 2 is currently up to date lending.

As you can see on slide 25, the Cards book has been managed carefully in recent years. We have selectively tightened our risk appetite in order to reduce exposure to more indebted customers. External data, as illustrated on the page, evidence this, albeit there are some differences in charge off policies between the different providers.

Spend levels have reduced across risk bands and this has resulted in customer balances falling across the book, including a 5 per cent reduction within the higher risk segment.

Now let's move to our Commercial portfolio on slide 26. The Commercial portfolio has also been subject also to careful risk management. Less than 3 per cent of Group lending, around 13 per cent of Commercial lending, is to the key sectors impacted by Covid-19. We continue to work closely with these clients, around a third of whom are investment grade.

As with the retail books, we have increased Stage 2 assets in Commercial by £10.8 billion in the first half, to £16.7 billion, or around 17 per cent of the portfolio. £16.2 billion of this, or over 95 per cent of Stage 2 balances, are up to date.

It is also worth noting that Commercial RCF drawings have fallen by around £6 billion in Q2, further reducing risk.

Meanwhile, we continue to be active participants in all of the Government-guaranteed lending schemes, including £7.3 billion of Bounce Back Loans and £1.8 billion of CBILS.

Now looking briefly at our SME and Commercial Real Estate portfolios on slide 27. Our SME portfolio has seen average write-offs of less than 0.25 per cent over the last three years and is around 90 per cent secured.

Our CRE book has been significantly de-risked, including through £6.5 billion of significant risk transfer transactions, and is also very largely secured. The average LTV is 49 per cent and around 70 per cent has an LTV below 60 per cent.

The CRE portfolio is also highly diversified, with only 15 per cent of the book in retail sectors while the office portfolio is focused on prime locations and clients.

Now let's turn to slide 28 on payment holidays.

We continue to offer payment holidays to customers in order to help them manage temporary financial pressures. Across products, over 1.1 million holidays have been granted to date, of which around 750 thousand are still in force.

A significant number of holidays ended in July and we are now seeing 72 per cent of mortgage customers and 74 per cent of card customers resume paying. This data is improving as more holidays mature and, importantly, we are also seeing low levels of early delinquencies across the products. It is also worth noting that some of these early delinquencies are very likely to cure. To be clear, customers who have sought to extend payment holidays are typically of a lower credit quality than the average. They tend to have higher average balances and lower risk scores. However it is also worth noting that in mortgages for example the average LTV is still around 52 per cent and in Cards, so far only around £70 million of balances have been extended.

As mentioned, we are confident that payment holiday risk is captured within our modelling and the significant increase in ECL that we took in Q1 and in Q2.

Now looking at slide 29, I will talk briefly about how we account for impairments under IFRS 9 and its relevance to H1 and H2. IFRS 9 requires us to recognise lifetime expected credit losses for loans in Stage 2 and 3.

As mentioned, Stage 2 includes a significant proportion of up to date customers who have only been moved because of modelled economic triggers. Indeed, the Stage 2 movement in the half has been predominantly within higher quality segments.

Assuming a stable macroeconomic forecast, Stages 2 and 3 are therefore already provided for within our ECL. You should expect the P&L charge in the second half of 2020 to reflect any unexpected single name moves within Commercial, future losses on Stage 1 assets as the 12 month window rolls forward including a charge for new business, and experience variances. Absent a change in macro assumptions, you should not expect to see a repeat of the significant uplift in Stage 2 assets that we saw in Q2.

Any change in the Group's economic assumptions could of course result in additional impairment charges and our sensitivities on the slide give you an idea of the potential quantum of this.

For example, a 1 per cent increase in unemployment would increase impairment by £294 million while a 10 per cent further fall in HPI would be £185 million.

I should also stress that the Group's IFRS 9 models produce the outcomes that drive the final P&L charge. We have confidence in the outputs from the models, but to be clear, we will be targeting to do better than the predicted ECLs.

Now moving down the P&L to look at the below the line items on slide 30. Restructuring is down 27 per cent on the prior year, largely due to our deliberate pause on severance and property rationalisation work for the duration of the lockdown. This will pick up in H2.

Volatility and other items of negative £188 million is 60 per cent lower than last year. This is largely due to £308 million positive banking volatility and the charge in 2019 that was incurred for changing asset management provider. We have again not taken anything for PPI in the second quarter. We remain happy with the circa 10 per cent modelled conversion rate, although note that processing activity has been impacted by the lockdown. Overall, we are comfortable that the unused provision of £745 million remains appropriate.

The tax credit of £621 million reflects the DTA re measurement benefit from Q1 and taxable losses in the second quarter. Going forward, I would continue to expect a normalised tax rate of around 25 per cent.

As a result of all of this, we end with statutory profit after tax of £19 million.

Turning now to slide 31 to look at risk-weighted assets.

Loans and advances are flat in H1. RWAs are up £4 billion in the half, but down £1.6 billion in Q2. In H1 as a whole, we have seen an increase of around £4 billion from credit migration and retail model calibrations, £1 billion from regulatory changes and £3 billion from market and other movements. This has been partly offset by lower retail unsecured lending volumes and continued optimisation activity within Commercial Banking.

As we look forward, given deteriorating economics, some ratings migration is likely. We expect optimisation activity to largely offset this and net RWAs to be flat to modestly up in the second half. Beyond that, in 2021 we may see some further inflation as delayed procyclicality impacts, which again, we will do our best to manage.

Now moving to capital on slide 32. Our CET 1 ratio of 14.6 per cent gives significant headroom over our lower regulatory requirements of around 11 per cent, as cushion against potential credit impairment. CET1 is benefitting in the half from the temporary addition of 79 basis points of IFRS 9 transitionals, to a total stock of 116 basis points. Potentially up to half of that H1 increase will unwind in line with the movement in staging in H2.

We also have 83 basis points in CET1 back from cancelling the 2019 final dividend. The RWA and other category includes several items, including negative 15 basis points for RWAs, offset by 11 basis points for excess expected loss and 17 basis points from positive banking volatility.

We have seen a 39 basis point capital hit from pensions in the first half, although it should be noted that this is partly because we made the full 2020 defined benefit pension scheme contribution in April in order to help with Pillar 2A management. One final point worth noting which is not in numbers is that if intangible policies are changed in line with current discussions, we would also expect a benefit in the second half of around 25 basis points.

Looking at CET1 requirements we have seen a circa 25 basis points reduction in the Pillar 2, partly because of the pension contributions I mentioned earlier. We will for now hold onto our ongoing CET1 target of around 12.5 per cent with a management buffer of around 1 per cent.

We are clearly comfortably above both our internal and regulatory target capital levels. As usual, the Board will consider dividends and buybacks at year end, when they will look at all available information, including in particular the economic outlook, as well as regulatory requirements.

Turning to funding and liquidity on slide 33. As with capital, our funding and liquidity position remains strong. We have completed £8.5 billion of funding to date across a range of products and currencies. We now expect a minimal funding requirement in the second half given the Group's access to around £40 billion of TFSME funding.

As you know, the Group's liquid assets exceed wholesale funding and we have no net wholesale debt. We also now have a loan to deposit ratio of 100 per cent, which in turn means that our loan book is entirely funded by our deposits. It also means we have plenty of opportunity to lend into a recovery, as and when appropriate.

Now wrapping up and turning to slide 34. The Group has very strong foundations and unique competitive strengths. Together these mean we are well placed for the evolving environment. As António mentioned, the strength of our franchise, our efficiency advantage and excellent track record of execution give us significant and enduring competitive advantage and will enable the Group to deliver long term superior and sustainable returns.

For now, the outlook remains highly uncertain and I would expect the impact of lower rates and economic fragility to persist for at least the rest of this year.

In that context, our guidance reflects our proactive response to the crisis and is set out on the slide before you.

In conclusion, I believe that we will emerge from this crisis having learned a lot about how our customers want to interact with us and the types of products and services they will need in the future.

We are learning a lot about ourselves and new ways of working. These emerging trends will challenge the whole sector but I have great confidence in the strength of the Group and the resourcefulness of my colleagues to help our customers and other stakeholders manage and succeed through the crisis.

Throughout everything, we will maintain our focus on supporting our customers and the UK economy. That is in the best interest of our Group and therefore our shareholders.

That concludes the presentations for this morning and António and I would be very happy to take your questions. Thank you.

Question and Answer Session

Question 1 – Raul Sinha, JP Morgan
Good morning António, good morning William. I have a couple both on NII if you don't mind. I just want to be clear on the drivers behind the step down in the NIM guidance and in NII versus Q1. And within that I was wondering if you could expand on two things in particular, one why do you assume that unsecured balances would be broadly flat given the cards book was down 9 per cent in the second quarter?

And then secondly if I look at the divisional trends, and this is hard to judge on a quarterly basis, but on a half yearly basis it looks to me that Commercial NII is down 16 per cent year over year whereas Retail NII is only down 7 per cent. So if you could shed some light on what is driving those two trends that would be really helpful?

William Chalmers
Sure. The H2 margin guidance that we have given. First of all I think it is just important to say our Q2 margin guidance came out pretty much exactly as expected when we gave you the guidance at Q1. At that point we wanted to give you guidance for how the business would operate in a challenging economic period through lockdown. But we did not want to give you guidance for the period beyond that and so we were quite deliberate in that. What we are giving you today is the guidance for the margin in H2 which is predicated upon the macroeconomic outlook that we have got and the balance of developments across the business in response to that.

So if I just spend a bit of time on that. The margin guidance, the guidance mentioned in one or two comments in the Presentation just given. For H2 it is driven really by four factors, two positive, two negative. And they more or less offset off the back of the Q2 margin of 240 that we have seen. The two positive factors are the evolution beyond interest free overdrafts which is obviously helpful from an unsecured perspective. And indeed the tailwinds for deposit repricing which we expect to see across Q3 and to a degree into Q4.

The headwinds to the margin are around rates and structural hedge. We expect about £15 billion of the structural hedge to roll off in H2. And then secondly mix contributions which in turn are coming from cards, from loans, to a degree from overdrafts. These are all in higher margin products which we expect to have sustainably lower balances going into H2. Now when we look at that it is important to make the comment that is very much tied to our view of activity in H2 and so if you look at our macro assumptions, we think they are relatively prudent in the H2 context. And they are spelt out as you know in the Presentation itself, also quarter by quarter in the RNS statements. But they are relatively prudent macroeconomic assumptions that then lead to the development of the balance sheet that underlies it. When we look at that balance sheet we are looking at around 5-10 per cent down from June levels for the development of the unsecured assets, so cards, loans, motor, on average 5-10 per cent down. By virtue of new business being slow to pick up and repayments continuing pretty much as they were before.

Now one can take varying, different views on that. That is our view, if one takes a more benign view of economic activity then you would expect that to feed through into balances which in turn you would expect to feed through into margins. We are trying to put everything together in a consistent manner and give you what we believe is a reasonable picture but also a prudent picture of things as they develop over the course of H2.

A similar picture on OOI. When we look at OOI there are a couple of points that are worth drawing out. We have one item within the H1 numbers, which I mentioned in the commentary, which is the Illiquidity Premium methodology change, that is about £90 million in the OOI number. That isn't going to repeat in H2. We also have an Asset Management Market Review charge which I won't put a number on but it is somewhere between £50-100 million depending on how it works out. And again that is a headwind going to OOI in H2.

There is probably overall relatively subdued activity again in line with our overall macro forecast which then leads the OOI picture being probably off a little bit as we go forward into H2 although we are not giving you explicit guidance on that because again it is so activity dependent.

I hope that answers the first couple of your questions. You also mentioned a question around Commercial NII versus Retail NII. There is nothing special really to call out there. It is just the margin development off the back of the different products written.

Raul Sinha
Is there no impact from the guaranteed schemes on the NIM in Commercial? Is that not material?

William Chalmers
Well there is an impact from guaranteed schemes, the Government sponsored lending activities, within Commercial and it comes through in CBILs and it comes through in BBLs in particular. But I think the overall impact of that on Commercial margin in H1 is pretty modest on the whole so I would not want to overplay that point.

Raul Sinha
Thanks very much.

Question 2 – Aman Rakkar, Barclays Capital
Morning gents, I just had a couple of questions. Just on the NIM. I note your comments around mortgage margins. It does look like they have widened pretty handsomely. Thanks for that data point on the 170 basis points. Does any of your NIM guidance basically factor in better asset margins, I mean are you basically assuming that it is not sustainable or is there any way for us to think about that potentially being a source of support for NIM if these levels can sustain themselves? And if so could you, if the current dynamic prevails, so 170 basis points, could you quantify what that benefit could be perhaps on a full year basis if the current levels sustain themselves?

The second question on other income, I think it is basically pointing to something like a billion pound run rate in each of Q3 and Q4 and so it would be good to clarify that and just get a view on what is the underlying run rate for other income now? It seems that is quite a noisy line and I appreciate it is activity based. But based on your view of a recovery in 2021 what might be a normalised underlying run rate for other income that we should think about for modelling next year?

So just a final one on capital. I mean there is quite a big gap between fully loaded and transitional. It sounds like you are going to basically close about half of that gap towards year end, given stage migration. I guess in the context of potential distributions, that you may or may not be able to take, you typically tied that to your CET1 ratio. I mean should we be thinking about your capital, when you think about how much capital you have, should we be thinking about the fully loaded CET1 ratio or versus what might be 40-50 basis points higher including the transitional relief? Thank you.

William Chalmers
First of the questions was on the mortgage new business margin. As you say that has been pretty favourable over the course of the last few months and that continues today. I think over recent quarters we have said the mortgage margin has been around 160-170 basis points. It is a blend of new business but also product transfers i.e. retentions. And it is greater than the maturing front book which is an important point because essentially what it is saying is that the price at which we are putting on new

incentive based business, you know a 2 year, 3 year, 5 year fixed whatever it might be, is better than the same incentive businesses dropping off the book from previously written years. So that overall mortgage margin is evolving in a positive way. The extent to which it impacts on the overall group margin will very much depend upon volumes. Volumes have been positive, certainly over the course of the last few weeks. We don't know, to be fair, whether that is pent up demand or whether that is an ongoing sustainable flow. We very much hope the latter, but it is early days to make that call. To the extent that it is a sustainable flow that goes on into H2 then again off the back of better activity one would expect that to feed through into the business.

The other point on the mortgage margin worth making is the SVR attrition has come down a little bit and that obviously helps as well. We have seen SVR attrition in previous years as you know circa 15 per cent or so. That is coming down to levels around 11-12 per cent depending on a particular time. But it is coming down, I suspect as a function again of lower levels of activity, but that seems to be settling in over the course of the first half of this year.

Moving on to OOI, I am not going to give kind of tramlines for OOI because again as we have discussed before, it is very activity based and we do see OOI trends very much according to the macroeconomics that we put forward. The OOI points that I would call out again, I made some of the points in Raul's question, is when you look at the first half in particular you have to knock out the ILP methodology change. That will bring us down from about 1.25 to about 1.15 or 1.16 or thereabouts. We will get a one-off headwind from an AMMR charge most likely in H2, probably within Q3 but we will see. And then I think beyond that we will have to see how markets develop. At the moment for example in the commercial space we are seeing very strong market activity just like most banks. We would hope that we will see some return of transactional banking activity in line with economic activity as a general matter. At the moment we are not banking on it, but one would hope that may be a positive development in that context.

In retail it very much depends upon payments flows. You have seen, as António mentioned, some positive developments in payments flows lately. But credit card is still a little bit behind debit card and it is really the former that would be helpful in terms of our overall payments premiums.

And then finally in Insurance, we are seeing relatively subdued core product markets. There are some comparison points there as I mentioned in my speech with H1 but we are seeing low interest rates, for example, are putting a bit of a dampener on annuity markets albeit our individual annuity market is actually doing very well. Our bulk annuity markets on the other hand like most aspects of that business across the sector are relatively slow. And that is kind of echoing its way across. So again I am not going to put tramlines on the OOI number but I think we will see a bit of a slowdown in the course of H2 versus what we have seen in the course of H1 but I wouldn't want to overplay it too much.

CET1, the third of your questions. CET1 we have a fully loaded ratio of 13.4 per cent. We have a ratio including transitionals of 14.6 per cent. That is 120 basis point difference which as you say is bigger than we have seen it for some time obviously because of the change in transitional regime in the first half of this year. You said, close half of it. It is not going to close that much. We are looking at around 40 basis points in the second half of transitionals running off. So in my earlier comments the piece that runs off is roughly half of the increase in transitionals that we have seen in H1. The increase in transitionals is 80 basis points, we expect about 40 of that to run off in the course of H2. Now importantly that depends upon the evolution of assets through stage 1 and 2 and into stage 3 which is the point at which they drop transitional relief as you know. So based upon our macroeconomic forecast, the 40 basis points gives you an indication of how that will play out. If developments are slower than we expect so the transitionals run-off will also be slower.

The final part of your question Aman was do we look at fully loaded or do we look at transitional? We look at transitional ratios when we look at the CET1 ratio and discuss it as to where we stand. But to be fair we also look at the economic outlook and we also look at the pattern and pace of expected regulatory change. So in some sense at least we are looking at both numbers in terms of how they move. The headline number that we look at is transitional ratio, but we are also conscious of the economic outlook that we go into and also conscious of regulatory change in both directions, positive and negative as it plays out in the course of the coming periods.

Aman Rakkar
Thank you very much.

Question 3 – Andrew Coombs, Citi
One clarification on slides and then second question on capital return. On the slide, thanks very much for the coverage ratios you have provided and a particular thank-you to your adjusted coverage ratio on credit cards adjusting to the charge-off policy. I think you said that stage 3 will go from 44 to 67 per cent after adjusting for that. Could you just clarify the 21 per cent on stage 2, what would that equivalent number be if you adjusted the charge of policy from 4 months to 12 months? It would be useful for us for comp analysis.

The second question on capital return. I appreciate it is early days, but I wanted your opinion on two trains of thought. The first of which is historically you have always had quite a large dividend and then you have supplemented that with a smaller buyback. Going forward would you consider doing it the other way around, a bigger buyback and a smaller dividend? Both given where your share price is trading over the discount to book, but also the flexibility that would give you.

And then the second attached question to that would be how do you think about your payout policy overall? Is it as a function of earnings or a function of the excess capital above the MDA? Thank you.

William Chalmers
Thanks Andrew. To address each of those, the stage 2 as you know is not in default so as a result we don't adjust it. And we don't provide the kind of pro forma number that you have seen on stage 3. And stage 3 as you pointed out in your question, that is all really about taking account of assets that actually have defaulted and saying well if they were still on our balance sheet and 100 per cent covered because they have defaulted and we have written them off, then what would our stage 3 look like to that. So that kind of pro forma comparison really only makes sense in stage 3 where we have effectively written it off and therefore taken 100 per cent coverage and we adjust it back into the numbers for a comparison purpose.

The second point on capital return is an important point. The capital strength of the business is clear for all to see really today. We have got 14.6 per cent transitional, we have got 13.4 per cent fully loaded. It doesn't matter which way you look at it, it is a very strong capital ratio relative to our internal targets and relative to our regulatory requirements. As we look forward the capital policy for now as we stand here in late July remains the same as it was. It will be for the Board to consider what the capital and indeed the distribution policy should be at the end of the year. And I am sure one of the factors they will take into account there is where we stand, both upon the expected developments that we thought we would see in H2 and what we might see in 2021 looking forward. I am sure they will also taking into account dividends and buybacks as alternatives as you say. But really that is a matter for the Board at the end of the year and today our capital policy remains as it was.

Now Andrew I didn't quite catch the tail end of your final question. If you could repeat it I would be happy to try to address.

Andrew Coombs
So there is the capital return question so a) the split between buyback and dividend and b) how do you think about the capital return, is it a function of the excess capital above MDA or a function of the payout ratio to earnings?

William Chalmers
The last part then maybe I will cover. As said I think this is all in the context of what are today, and what we frankly expect to continue to be, very solid capital ratios going forward. But the matter of distribution again is really for the Board at the end of the year. They will look at a variety of different parameters and we look at capital metrics including the MDA and the buffer above MDA that we choose to have is certainly one of them. We look at one or two other metrics as well including external and our internal stress tests.

The other ingredient to all of this is not surprisingly the outlook that we see. And so as we progress towards the end of this year, again we will take into account what we have seen, based on what we believe are relatively prudent economic assumptions and also what we expect to see going forward into 2021. And then I think the Board will be positioned to decide on capital distribution at that point.

Andrew Coombs
Thank you and just coming back to the first question on cards in that case. I appreciate your point on stage 2 and stage 3 as well as taking a charge-off. I guess the issue is when we look at your stage 3 coverage it does look comparable to peers but stage 2 coverage looks a little light. So any thoughts on why your stage 2 coverage should be a little lower in terms of your peer group?

William Chalmers
Yeah happy to answer that Andrew. It is worth bearing in mind the card portfolio we have is a prime portfolio and frankly has been increasingly prime over the years. It is lower risk versus others and we show you some delinquency data in the presentation that we think lends testimony to that. There are different charge-off policies in that, fair enough, but none the less even after you adjust for those we think the delinquency points stands. We also, based upon externally available data, see ourselves as having lower balances and higher credit scores versus others and again that is based on external data rather than our own internal observations. And then we have that charge-off policy but as you rightly say that is a stage 3 point as mentioned earlier on. So I think the overall

portfolio strength that we see combined with some of the deleveraging that we have seen in the first half of this year including amongst high risk customers who have been around 5 per cent deleveraging on that card portfolio, makes us feel very comfortable in terms of a) our prudent macroeconomic assumptions and b) our coverage levels within that.

Andrew Coombs
Thank you for answering my questions.

Question 4 – Robert Noble, Deutsche
Morning all, thanks for taking my questions. Just a clarification on NIM if I look out to 2021. Is 240 basis points the level that we should be thinking of going forward or do you expect that to improve in forward years?

And secondly, if you look at the kind of returns on normalised impairments we are getting given the lower margin and lower activity where things should rebound a little bit. But you think it is going to be much lower? What are you going to do about it in the long run to kind of get your returns to sustainably premium to cost of equity and is it worth looking at collapsing the multi-brand strategy now given the returns?

William Chalmers
Okay thanks for your question. On the net interest margin point, as you know we are not giving 2021 guidance today so I want to steer off of that. It is fair to say without giving that guidance it is fair to say that we are going to have an interplay in 2021 on the net interest margin lying between what are the levels of activity and how fast do those return. What are the product margins, how does the structural hedge play out in the course of that year. So all of those things as you can imagine are going to be interplayed into the margin. I do think that it is worth calling out there is a very unusual dependency right now between activity levels and the margin and that is simply because the activity levels are driving relatively subdued levels in H2 of unsecured in particular. As those activity levels start to get back to normality so it tilts the balance and tilts the margin. So that dependency is particularly acute right now and hopefully that will play out in a more benign way during the course of 2021. The same is true as we said earlier on other income. So if you see the activity levels return, if you see a stronger macro, we are geared into it. So the guidance that we have given is and remains for 2020. We are comfortable with that within the given macro context that we are describing there.

Now moving onto your second question, returns on the business. Again I don't want to give guidance on anything beyond 2020 at this stage. And as I said the strategic review work that we are doing very much carries on its business as usual in that respect and we will be launching a strategic review in the course of 2021 in line with the new CEO. The points that I would make though is that historically this business has yielded returns on equity that are systematically in excess of the cost of equity. I don't, over the long-term, expect that to change. As we look at our internal dynamics of the business, we look at the business model, we look at our outlook, even in the flat rates environment and with stable margins and with the initiatives that we have across the business, then we see ourselves being back to ROE in excess of cost of equity within 2-3 years, recognising that 2021 is likely to be a transitional year. So without going into further detail, I mean that gives you hopefully a bit of a shape to answer your question.

António is there anything you would like to add?

António Horta-Osório
To build on what William just told you. I think there are three important points to add on your question. The first one is our multi-brand is a core part of our positioning and our strategy in the UK. If you look at Halifax brand, we treat the position of the brand across the whole of the UK while Lloyds and Bank of Scotland are basically the High Street brands in both Scotland and England and Wales, Halifax goes across the whole of the nation. And has a completely different customer base. So for Halifax, when you look at segmentation by attitudes and by what customers want, they are very different from the Lloyds and Bank of Scotland customers which are similar in terms of attitudes and segmentation although geographically separate. As a result we have a very low overlap of the two brands. And one of the key points which I think enabled us to have a much lower cost:income than others is this capacity of segmenting through the brands and at the same time we have centralised everything that the customers did not see, so a single finance function, a single HR function, a single risk function and although we have slightly higher costs given that the brands are different and have different offerings. We have as a whole, better segmentation, so higher incomes and a much lower cost to income. So that is the key part of our proposition.

And the second point I would like to make relating to your question is that the reason why William and I are very confident that this business has all the capacity to pay out and to have a return on equity above the cost of equity is exactly as well because of the cost to income. Because we have a very significant advantage in cost to income versus the average of the sector and any of the other peers. As mentioned before and in my presentation, this is a fundamental competitive advantage when you think that it enables us to create capacity to invest more in the business which through automation and other mechanisms lowers cost continuously and through a better customer experience improves NPS scores and therefore revenues over time. This makes the cost to income over time also go down and creates the virtuous circle as I mentioned which also enables us to pay over time superior returns to investors. When you look at the cost to income in this current pandemic environment you see an additional advantage which is it enables us to withstand much higher than unexpected shocks, in terms of provisions given that a low cost to income means a much higher pre-provision profit as a percentage of revenue. So I think this is a really important thing and as you know cost discipline is key in several dimensions and it is really the only lever which is totally within management control. And our track record on this is clear in this area.

Robert Noble
Thanks very much.

Question 5 – Martin Leitgeb, Goldman Sachs
Good morning. I just wanted to follow-up on earlier comment in terms of how do you think about margin and I was just wondering, looking at your base scenario of roughly 6 per cent decline in House Price Index. What kind of offsetting factors could there be from the SVR book? Could there be a scenario where attrition in the SVR book could slow down significantly or even come to a halt if house prices were to fall according to your scenario? And given the sheer quantum of contraction in card debt year to date, I was wondering, this seems to be a very unusual recession in terms of the speed of the economic impact, could there be a scenario that we could see an equally fast speed in terms of recovery, in terms of build up of the credit card book in 2021?

The next question, I was just wondering what your thoughts are with regards to the discussion around negative rates in the UK so number one is the bank prepared for it and maybe if you can help us in terms of how much of an impact in terms of revenue headwinds would be from the introduction of negative rates in the UK?

And finally, on Brexit, I was just wondering, given where discussions are going in terms of the future agreement with the European Union, what potential impact do you see for your business going forward in terms of activity levels and support? Thank you.

William Chalmers
I think there are four questions there which I will work my way through. The first one on the NIM and the SVR position in particular there. As you know on the net interest margin for the second half of this year we pulled out four factors, two positive and two negative. I won't rehearse those again. But in addition to those four factors there are as you rightly point out one or two other pieces going on. The higher mortgage rate has been discussed earlier on. The SVR churn is a further one of those. Built into our modelling is a very historic path dependent view on the SVR attrition which isn't awfully different to what we have seen over the course of the last year or so. But it does not take into account the SVR attrition level as low as what we have recently seen. I think the SVR attrition recently has come down partly because activity is lower in the mortgage market and I suspect that if we see that play out and maybe augmented as you say by HPI falls, one would naturally expect that to have some relationship with SVR attrition, i.e. if HPI does fall you would expect SVR attrition to perhaps be a little bit slower off the back of that. We saw that a little bit in the course of the last cycle so we might see it in the course of this one, albeit in the last cycle as you know the HPI hit was not particularly significant. So there could be a relationship there. We are not banking on it, it is not built into our expectations, but it is possible.

The second point, card book, could we see a recovery fast? In a sense this goes the other way. I think the answer to your question is yes, one could see a very fast recovery and we saw some of the early callouts from the United States in particular when some of that recovery was evident but that maybe backing up a little bit recently in the US. But nonetheless it does illustrate the point that actually this is something that could turn around relatively quickly. I hesitate to speak too anecdotal about it but you look at the holiday experience over the course of this summer, if that ever gets going in earnest then you would expect payment volumes and in particular credit card payments volumes to accelerate off the back of that. And those transaction revenues are important to the business. Likewise you expect expenditure on consumer durables for which credit cards are normally used to start to increase. And so we could see a relatively fast recovery in the card book. As said, we have seen that in debit, we haven't seen it in credit. Our economic assumptions are what they are and are set out in the presentation material. They are not banking on that recovery. To the extent that it occurs, it could be fast and if it does one would expect that to reflect itself in the business.

António Horta-Osório
And to add a point which might be helpful to Martin in terms of the overall picture in unsecured, because you are right Martin, this could happen. Something that would go in the direction of your question, if you look at consumers behaviour so far during the pandemic as both William and I mentioned, the consumers are absolutely doing the right thing in sense that that they are

decreasing leverage and they are increasing savings. So from the risk point of view they are taking the time of the furlough scheme to adjust their behaviour in a prudent way. And if you look more broadly macroeconomically you can see that the unsecured debt as a percentage of disposable income is now more than a third lower than pre-crisis level. So when you go to 2006, unsecured lending as a whole was around 22 per cent of disposable income and the latest numbers are only 14 per cent and I should remind you that 14 per cent includes 2 per cent of the guarantees through the PCP contracts. So you see it is more than a third down. In that sense, consumers will have room if the economy is quicker than is expected, to put on more consumer debt even as they have deleveraged very significantly and rightly so and they are using the support measures from Government in order to continue to deleverage which puts them in a more prudent and stronger position.

William Chalmers
The third of your questions Martin, negative rates. Negative rates is a difficult call actually. There are many different forms of negative rates introduction as you know. First of all the debate is not there yet, it seems that the Bank of England is committed to trying out other forms of stimulation including in particular QE before we get into negative rates territory. And that stance is one that I think has been pretty clear. If it gets into a negative rates discussion then I think there are very different forms in which negative rates can play themselves out or be introduced into the economy. There are also a number of different offsets that the Bank of England could put in place to offset against the effect of negative rates as it plays out in the banking sector. And so TFSME is one example of that or TFS more generally is one example of that. And whether or not there will be any compensating negative funding benefits for the banks to draw upon from the Bank of England would obviously be a question in terms of the negative rates impact on the overall business.

And then furthermore pricing strategies. We note the pricing strategies that have been adopted in Europe particularly for commercial and larger corporate accounts for charging for balances. We have not taken any view on what the pricing strategy will be in a negative rate environment. But the point is, it is noted that there are pricing strategies that could offset against the impact of negative rates depending upon how they are introduced. I think there is no doubt overall negative rates are for the banking sector as a whole not especially good news. They haven't been particularly in Europe, they haven't been particularly in Japan. But I think there are a number of questions and indeed offsets to the negative rates debate which in turn could considerably soften the impact if it ever got there. So my concluding point on that would be to say we are not there as of today and there is nothing that we are hearing at least that suggest that we are going to be there tomorrow. But it is a risk as you are right to point out, it is a risk that is out there.

Finally, Brexit. The Multiple Economic Scenarios that we have taken as you know encompass a range of different outcomes. We have taken a base, a downside and a severe downside and actually an upside which if you look at it closely is not terribly different to a base and therefore we think relatively conservative. But the severe is really as the name suggests, quite a severe downside for which we take a 10 per cent weighting. That includes things like HPI down 30 per cent over the forecast period. It includes things like 12.5 per cent peak unemployment. It includes things in 2020 actually, 17 per cent GDP and thereafter a relatively slow improvement in succeeding years. So severe is deliberately and quite consciously quite a severe downside. Now I don't know what Brexit will throw at us but I would very much hope that our severe downside encompasses more than what Brexit will throw at us. And so again we don't have a Brexit overlay, we don't have a Brexit output but we do have a set of MES assumptions that we think are pretty prudent and we believe should encompass some if not all of what Brexit will throw at us.

Martin Leitgeb
Thank you very much.

Question 6 – Guy Stebbings, Exane BNP
Morning, thanks for taking the questions. Firstly I wanted to talk about RWA growth and your guidance there for flat to modestly up. Given some of the comments you have made around assumptions on unsecured shrinkage and growth coming from lower risk weight dense assets. Shall we assume that that is building in quite a reasonable amount of negative credit migration or is there anything else going on that you would point to?

And then secondly I just wanted to ask about the insurance business and the solvency position which has dropped to 140 per cent. If you could talk us through your risk appetite there in this environment and any actions you might take or implications for future insurance dividends would be helpful. Thanks.

William Chalmers
Thanks. Dealing with the first of those two questions, the RWA growth point. So far it is worth saying credit migration has been negligible in the overall business. I mean if you look at the developments during the course of H1, the contribution of credit migration in the RWA development has so far been very, very limited. True for both corporate and retail in fact, retail to the extent there has been any increase in RWAs is actually because of countercyclical models off the back of benign arrears development

in Q1 of this year. Not because of a worsening of the situation. Commercial has been more traditional credit migration but in H1 of this year it has been less than a billion. And so I think so far we have seen very little. As we go forward, the RWA picture we have described as you know is flat to modestly up and we have deliberately left ourselves a little bit of room there just to reflect to a degree the uncertainties and perhaps a little bit of temporal volatility around RWAs as to say you might see a few ups and downs around the RWA picture.

So within that what do we see? We see obviously some linkage to volumes so to the extent that we see unsecured coming off with some benefit, some impact or benefit from that in terms of the higher RWAs associated with it, not huge but it is there. There is also a question around regulatory forbearance and how that will play out. To the extent that interest free overdrafts for example are continued which we don't have any particular reason to believe they will be. But if they are then it will be contingent upon us asking a customer if they need that overdraft. If they do need that overdraft then that in turn would have an RWA impact upon us as it will be treated as forbearance. It also depends on default development. We obviously have got a view in our base case on how defaults will develop over the course of H2. That in turn drives RWA impacts. And then we are carrying on with our optimisation activity in the commercial book through which we expect we will offset a lot of the RWA developments that might otherwise take place.

And then somewhat deliberately last on the list, the credit migration. The credit migration is obviously quite uncertain. We don't anticipate it to be huge, we do anticipate it to be offset by optimisation as said in commercial over the course of H2. But we are deliberately leaving ourselves just a little bit of manoeuvrability in the RWA numbers by saying flat to modestly up. And that is simply because of those uncertainties that I have described. A good outcome for us would be flat. I think an outcome that would be slightly less than we would hope for would be modestly up. And that is the kind of range guidance that we are trying to give.

Second of your two questions. The insurance solvency levels as you rightly point out is 140 per cent. That is pretty much in line with what we would ideally seek to run the business by and occasionally we will have a little bit of cushion above that and occasionally we will have a little bit of a draw down below that. But 140 per cent is not far off what we have seen and like to see the insurance business run itself on, on an ongoing basis. If we look at that going forward there is kind of a number of points there. I mean obviously there is the ongoing business which will build up the solvency through earnings contribution over time. Secondly there are kind of risks in terms of development of the economy and potential downgrade risks going into the second half and those go the other way. So the contributions to that insurance solvency ratio goes both ways. I think overall when we look at the portfolio of credit exposures within the insurance business we see them as being generally a very high quality set of portfolios. If you look at the annuity backing portfolio for example of £17 billion, 40 per cent of that is triple A or double A rated. If you include single A's, it is 75 per cent and it is only 1 per cent sub-investment grade. In the half year to date we have seen £87 million downgrade so really very modest downgrades off the back of that portfolio. And again looking at it as a high quality portfolio going forward. So when we look at the insurance company as I said, 140 per cent solvency feels about right.

As to your question as to dividends out of that business, again we will have to take a view as to what the economic outlook is like and how the business is performing. That will be a matter for the Insurance Board and the Group Board at the back end of the year.

Guy Stebbings
Okay, thank you.

Question 7 – Fahed Kunwar, Redburn
Hi morning and thanks for taking my questions. I have a couple of questions on margins, one of your peers talked about deposit cuts coming in at the back end of the quarter in the UK and potentially more coming through in this quarter. Are there any deposit cuts that have come through and how much headroom do you have on the liability side of the balance sheet?

Then a question I had was on back book margins, I appreciate you said the SVR attrition is slowing. But do you have numbers on what the back book versus the front book is on your mortgage portfolio?

My third question, can I ties this together, I appreciate there are pluses and minuses on margins. But as it stands right now, your hedge is annualising at £1.2 billion net, that is 25bps that is going to disappear unless the yield curve steepens, assuming your back book to front book is negative as well. So quite a lot of mechanical pressure on your margin, probably in the region of 89bps per annum. Just before even starting to think about activity levels. Am I right in thinking you need to have quite a lot of positive things to think the margin will keep from deteriorating from here or am I doing something wrong with my maths? Thanks.

William Chalmers
Thanks for the question. I may repeat a little bit of what I have said here, but I will do my best to be a bit more specific on the question. Probably without getting quite as far as you might like me to. When we look at the margin, as we said, we have got a number of factors going on in it. You ask specifically about the deposits repricing, so far and the headroom left for liability repricing looking forward. There has been a little bit, a modest bit of deposit repricing so far in the business and we have seen a bit of that in the course of Q2. But as said earlier on there is more of that to play out in the course of Q3 and Q4 particularly in the commercial business which in turn will feed its way through into the numbers. I won't put a precise number on either what has been taken or what is to come, but just safe to say there has been a little take in there and more coming in the course of Q3, Q4. That is all absorbed in our overall margin guidance for the remainder of H2.

In terms of headroom left on the retail and commercial liability portfolio. The answer is there is not terribly much. We are close to flooring out on the liability margin. It probably doesn't surprise you much in terms of where base rates are and where as you know most of the products are. There is some, I mean you could probably point to individual products which I won't list by name but there is probably some in certain product areas within retail and commercial that you could draw from if you chose to. But at the same time we would be conscious of the longer term picture in doing so and the desire to maintain the strength of the franchise in doing so. So a little bit more to play on there, but frankly not an awful lot.

In terms of the mortgage portfolio, I mean I think it is an interesting one, there is a lot of dynamics going on there as we mentioned earlier on. We have seen recent quarters between 160 to 170 basis points on front end mortgage margins. That is better than the products they are replacing on an incentive base structure. So the blend of new business and product transfers, i.e. retention is a better picture versus what is retained, and that is supportive to the margin not negative to the margin. And I would suspect just as we saw in the last crisis, when people's capital bases start to get hit as they are doing in this crisis, many of your competitors tend to withdraw products from the market and that withdrawal of products in turn tends to be supportive of the margins not just in mortgages frankly but across the board. And so that is what we saw in the last crisis, it may be that is what we will see in this crisis. It may already be feeding through into some of the mortgage comments I just made. But I think one should be very careful before drawing the conclusion that we are on a kind of relentless downwards path on margins. Actually the experience of most banking crises is that when capital gets hit margins actually tend to go up in compensation for that. And let's see whether that happens here, but I think that would not necessarily be an unreasonable outlook to have.

António Horta-Osório
If I can just add two points to what William said which might be helpful. The first one on mortgages is that you have to bear in mind as well that given that the market has been shut for 2-3 months, activity is now resuming and customers are now doing transactions again, there could be more time than usual in terms of new business application margins translating into completions margin because of reactions to the Coronavirus. So normally you have 90 days between applications converting into completions and this could take a bit longer and so go into next year to the point William was saying and has mentioned in a question before.

And the second point is about the mix. We are forecasting a recovery next year, so GDP could go down on base case 10 per cent this year but up 6 per cent next year. Possibly we see activity up, and that should bring the mix back into a normal direction and through mix with credit cards for example recovering and motor has already recovered, we also have an impact on margins through mix as we have been impacted negatively in the second quarter as William explained, could revert next year.

Fahed Kunwar
Thank you.

Question 8 – Jonathan Pierce, Numis
Good morning both. Quick questions you will be pleased to hear. Just to check my maths on the structural hedge, all in yields 1.4 per cent, the five year swap today is at about 15 basis points. You have mentioned William, straight line roll off over the next three years. So are we looking from that component within margin a sort of 10 basis point headwind a year, in 2021, 2022 that would be the first question.

The second question on capital, obviously the capital numbers looking good at the moment. There are some headwinds building, but what I wanted to ask about was pensions. You may just say we are not telling you yet, but I am interested in how those discussions are going given the fairly sizable contributions currently planned for the next few years? Thank you.

William Chalmers
Thanks Jonathan. On the structural hedge just to take the first of those two questions. The roll-off as I mentioned in comments earlier on is pretty much in a straight line. The weighted average life is now 2.5 years, the hedge itself has a life of about five

years. So pretty much straight line within that five year profile. I would be a little bit careful before necessarily directly correlating that to the income streams in a very precise way because there are different maturities that have different yields attached to them so it might be a little bit bumpy. But I think in the absence of us giving you more precise guidance I think just take that as an assumption but just be aware of the fact there may be a few bumps along the road. I do think that when we look at the structural hedge as you know we take a view that is around protecting shareholder value and take the view that it is around protecting the consistency of earnings. And when we look at the structural hedges and as we seek to deploy it over the coming years, obviously we will be subject to whatever it is the rates environment throws at us. But we will also be judicious about what we do with the structural hedge and when to ensure that we both achieve income consistency and also shareholder returns. So the profile of it will depend upon how we reinvest the structural hedge over what time and in that context what opportunities and rates market may give us and what the trends in the rates market may be.

The capital point as you said, and I would endorse, the capital position remains and will remain very strong. Now, the contribution of pensions to that. It is worth just noting that our Pillar 2A has come down by 30 basis points in the second quarter and that is because we accelerated our 2020 pension contributions by around £600 million which in turn led our Pillar 2A to come down off the back of that and leads to our regulatory capital requirements coming down off the back of that. So that is helpful. As we look forward and as you pointed out, we are also in renegotiation with the trustees which takes place as of a balance sheet drawn at the end of 2019. That balance sheet is drawn at the end of 2019, and that is kind of close of play for negotiations. We are in the process of discussing with the trustees about how we make contributions to the scheme going forward, taking into account all their objectives and also taking into account our objectives. So I am sure we will end up at a kind of reasonable spot that considers each of those two in a way that is mutually satisfactory. But I am not going to go beyond that Jonathan just because it is the middle or even the start really of a negotiation.

Jonathan Pierce
Yeah understood. It is interesting that Pillar 2A has come down, almost, well has come down in the same half year as those accelerated contributions. Is that what you would expect going forward, an almost instant decline in Pillar 2A as these contributions are made?

William Chalmers
There's a couple of capital points worth pointing out as we go forward. And we talked about the transitional effect and we will see exactly the timing of how that plays out. But the other couple of capital points worth making are we have the developments within the countercyclical buffer so we will see how they play out during the course of the year. But at the moment it looks like there maybe 25 basis points equity release in the context of the countercyclical buffer. But there are discussions on exactly how that will play out particularly in the context of the reintroduction in the years subsequently. And that is up in the air clearly.

The other point is intangibles. Intangibles, we would get around a 25 basis point benefit from if that comes through in the form that is being discussed for the end of this year. So it doesn't answer your Pillar 2A point too precisely Jonathan but I hope that gives you some guidance.

Jonathan Pierce
Great, thanks a lot.

William Chalmers
I am sorry that we have now run out of time so I just want to thank everybody for dialling in. We will contact all of those who were unable to ask questions and make sure that anybody who asks questions are able to do so to the IR team. So straight after this call and during the course of today and tomorrow we will make sure that any questions that are not answered do indeed get picked up. But I hope this has been a useful call. We have been going for now over an hour and a half which hopefully has given everybody an opportunity to hear the speeches and address some questions.

Thanks very much indeed for dialling in.

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