LLOYDS BANKING GROUP PLC – 2021 HALF YEAR RESULTS – PRESENTATION Q&A TRANSCRIPT

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LBG:
William Chalmers, Interim Group Chief Executive

William Chalmers
Good morning everyone and thank you for joining our half year results presentation today. I will shortly turn to an overview of the progress that the Group has made in the first half of the year on Strategic Review 2021. I will then give an overview of our solid financial performance and the continued business momentum we have seen in the first half. As usual, there will be plenty of time at the end for Q&A, for which I will be joined by Jon Burgess, our Deputy Group CFO.

Turning first to slide 2. During the first half of the year we have delivered for our customers and we remain determined to continue to support them in the current recovery. We are making good strategic progress, we are building the franchise and we have delivered continued solid financial performance. The Group's balance sheet and capital position is strong, underpinned by capital build of 93 basis points in the half. This has enabled the Board to announce an interim ordinary dividend of 0.67 pence per share.

As we look forward today, over 18 months since the start of the pandemic, we are seeing some signs of economic recovery and have updated our forecasts accordingly. In this context, given our performance and the macroeconomic backdrop, we are enhancing our guidance for 2021. This includes a stronger NIM outlook for 2021 and a lower credit charge, in turn resulting in a slightly higher cost base as we accelerate the rebuild of variable pay. Together, this leads to a return on tangible equity of circa 10 per cent, ahead of previous guidance. We also expect RWAs to be below £200 billion.

I will now turn to the strategic progress we have made during the first half of the year, shown on slide 3. We are making good progress on Strategic Review 2021, the current evolution of our strategy that sets out clear execution outcomes for the year, underpinned by long-term strategic vision.

As you know, our purpose is to Help Britain Prosper. Within this, in 2021 our focus on Helping Britain Recover has been on the areas where we can make the most difference. We have delivered in the first half. We have expanded the availability of affordable and quality homes by lending around £9 billion to first time buyers, almost reaching our target for the full year. We have already exceeded our target for social housing sector funding for the full year 2021. We have supported over 48 thousand businesses in start-up, out of our 75 thousand target for the full year. We are also delivering on our objectives to create a sustainable and an inclusive future. As well as making progress towards our diversity goals, we were recently ranked 6th in the Financial Times' inaugural list of Europe's Climate Leaders.

Turning to our customer ambitions on slide 4. During the first half, we made real progress across our core business areas, delivering growth while increasing customer satisfaction and enhancing our product capabilities. We have delivered increased satisfaction scores for both personal customers and businesses, further improving our record all channel NPS to 71. We have grown the open mortgage book by more than £12 billion, our strongest half yearly growth in over a decade, as we have supported customers in their housing preferences in the post-pandemic context. We have also improved our position across core Markets products, with our GBP rates ranking improving from 10th place to 6th.

As you know, enhancing our Wealth offering is a core element of our customer ambitions. In the first half we delivered £4 billion of net new money in Insurance and Wealth, reflecting a 7 per cent annualised growth rate.

This morning we are excited to announce the acquisition of Embark, a fast growing, investment and retirement platform business, with assets under administration of around £35 billion, on behalf of circa 410 thousand customers. This acquisition completes the Group's Wealth proposition by enhancing our capabilities in the attractive mass market and self-directed Wealth segment, while also significantly strengthening our offering in accumulation and Retirement, important growth markets.

Embark's existing business and technology capabilities will enable the Group to deliver a modern, leading direct-to-consumer proposition and new platform services for our share-dealing business and the IFA sector. The acquisition therefore provides strong growth potential. We are targeting a top 3 position in the individual pensions and drawdown market by 2025, as well as a top 3 position in the self-directed, robo-advice market in the medium term.

Stepping back, Embark is entirely consistent with, and supportive of, our Strategic Review 2021 targets. Indeed, we are increasing our 2023 net new money target from £25 billion to circa £40 billion, to reflect our now increased growth potential. Embark will also contribute towards our ambition to build income diversification, which is particularly valuable in a low rate environment. We are targeting a mid-teens return on invested capital in the medium term, including all integration and restructuring costs.

I will now look at our focus on enhanced capabilities in Strategic Review 2021, on slide 5. Strategic Review 2021 identified four capabilities that are critical to sustainable success – technology, payments, data and ways of working. In the first half of the year we have made steady progress in all of these areas.

In technology, we continue to improve our digital offering for customers, including bringing new features and updates to the market more quickly and more efficiently.

In the first half of the year, we safely migrated around 120 thousand customer accounts to our pilot new bank architecture. This is less than the 400 thousand originally planned, but sufficient to provide the necessary proof-point for our investments, build confidence for our cloud plans and allow work to progress.

On payments, we are on track to deliver a threefold increase in the number of clients onboarded to our cash management and payments platform. We have also maintained our leading card spend share, in line with target.

We are continuing to improve our use of data, migrating 45 million customer records to cloud hosting. This was another important proof-point.

Finally, in respect of ways of working, we are preparing for around 80 per cent of our colleagues to be working in a hybrid manner in the future. This provides scope for efficiencies in our office footprint, with a circa 3 per cent reduction delivered in the first half and on track for a full year reduction of 8 per cent.

I will now move from strategy to our operating environment and turn to the UK economy on slide 6. As mentioned, we are beginning to see signs of an economic recovery, although uncertainties clearly remain. GDP and growth expectations have both picked-up over the quarter. Business confidence is rising strongly, as are expectations for staffing levels over the coming year. Together these are key indicators for the SME sector which, of course, is very important to us. In March, the Coronavirus Job Retention Scheme was extended to the end of September. This provides a significant level of support for people across the UK, although notably fewer people are on furlough than a year ago.

We are also seeing spending recover. Combined credit and debit card spend is now above pre-pandemic levels, although not yet translating into credit card balances, given high repayments. So, while there is uncertainty around virus development and what will happen when furlough ends, we are nonetheless seeing positive trends.

I will now turn to the financial update, beginning on slide 8. Financial performance of the business has been solid in the first half, with Q2 consolidating trends established in Q1. Net income of £7.6 billion is recovering, up 2 per cent on prior year and up 8 per cent on the second half of 2020.

NII of £5.4 billion is supported by higher average interest-earning assets of £441 billion and a margin of 250 basis points, which has further strengthened in Q2.

Other income at £2.4 billion is up 18 per cent on the second half of 2020, although this is partly due to some non-recurring items, which I will explain shortly. Net income also includes a £271 million operating lease depreciation charge in the half. This is below our typical run rate, but broadly in line with our expectations for the rest of the year, given the continuing strength of used car prices.

Operating costs continue to be a focus and our cost:income ratio is market leading at 54.9 per cent. We are also accelerating the rebuild of variable pay, which adds to costs but reflects our stronger-than-expected financial performance. We also saw a higher remediation charge in the half. This primarily relates to the historic insurance renewals fine, the HBOS Reading re-review and other ongoing legacy programmes. Underlying asset quality is strong. Combined with the improved macroeconomic outlook, this supports a net credit in the half of £656 million.

Taken together, statutory profit before tax was £3.9 billion, significantly higher than prior year and a solid recovery. As part of this recovery, we have seen continued balance sheet growth and capital momentum in the half with our CET1 ratio now at 16.7 per cent. I will expand on these points shortly.

Now let me turn to slide 9 and cover the net interest income developments during the half. Both average interest-earning assets and net interest margin were up on the second half of 2020.

As you can see on the slide, the strong mortgage book growth was again the main driver of the AIEA growth. Looking forward, while we expect growth to moderate, we have a solid mortgage pipeline for Q3 and in line with our macroeconomic assumptions, expect a modest recovery in unsecured balances in H2. This means we continue to expect low single-digit percentage growth in average interest-earning assets in 2021.

The H1 margin of 250 basis points was up 6 basis points on H2, while the Q2 margin of 251 basis points was up 2 basis points in the quarter. In H1 2021 versus H2 2020, lower structural hedge income and the impact of lower cards balances were more than offset by the benefit from continued optimisation activity in the commercial book, strong deposit flows and liability management benefits.

Looking forward, the mortgage market remains attractive but we are seeing pricing becoming more competitive and will continue to be disciplined in our approach. We also expect increased structural hedge income, improved funding and capital costs and the modest growth in unsecured lending which I mentioned, to support the Group margin in the second half. All taken together, we now expect the NIM to be around 250 basis points for the full year.

Turning to slide 10 and the lending performance and asset margins in a bit more detail. I have talked about the strong mortgage performance that we have seen, particularly the growth in the open book. Completion margins have been around 175 basis points in Q2, which remains above front book maturities, although it is down from the 190 basis points that we saw in Q1.

Briefly on the back book. We have seen SVR attrition increase slightly to around 15 per cent. However, given a smaller book, the absolute reduction in the size of the back book is broadly comparable to prior periods. As you can see on the slide, consumer finance volumes have largely stabilised in the second quarter, but are still down on prior year, particularly in cards. This has clearly impacted the margin. However, notably, card volumes ended Q2 in much the same position as Q1, showing balance reductions have now levelled-off.

In Commercial Banking, the margin in H1 has benefitted from an improvement in the asset mix, as well as ongoing pricing actions.

Now let me move to slide 11 to look at deposits. Deposits have increased significantly in the first half of 2021, up £23.7 billion as we have continued to see inflows to our trusted brands.

In Retail, we have seen inflows from new and existing customers. Average current account balances have increased by almost 40 per cent since 2019, given reduced customer spending and higher levels of saving.

Commercial deposits are up £3.7 billion in the half, although this includes a temporary pick-up in legal accounts in June, for mortgage volumes before the phased resumption of stamp duty. The significant increase in deposit balances, which is now £63 billion since the end of 2019 gives the Group further opportunities to serve customers through our enhanced wealth offering, including today's acquisition of Embark. It also increases our pool of hedgeable balances.

The deposit margin of 15 basis points was broadly in line with the second half of 2020 and continues to support a lower overall Group funding cost.

I will now turn to slide 12 to look at the structural hedge in a bit more detail. As you heard at Q1, in the context of our continued success in attracting deposits, we increased the structural hedge capacity by £15 billion to £225 billion. Hedge capacity has now increased £40 billion since the end of 2019, which is prudent given the deposit growth we have seen over that same period. We have also acted upon the favourable yield curve movements and reinvested the notional balance up to £215 billion, an increase of £29 billion in the half, including £8 billion during the second quarter.

The weighted average life of the hedge is now around 3.5 years, essentially in line with the position at Q1. As you can see, we have around £10 billion of unhedged capacity. Along with £30 billion of maturities in H2, there is therefore flexibility to invest, depending on the environment and to ensure our objectives of earnings stability and shareholder value.

In H1, we have seen income of £1.1 billion from hedgeable balances. Given our continued deployment into the more positive yield curve environment and the increase in the size of the hedge, we now expect earnings from this area to be stronger than previously estimated. Based on current market rates, the headwind we now expect in 2021 versus 2020 is circa £250 million. We do not expect to see a headwind in 2022 and only a modest headwind in '23.

Now turning to slide 13 to look at other income. Other income of £2.4 billion includes £1.3 billion in the second quarter. This is clearly ahead of our recent quarterly run rate.

The performance benefits by just under £100 million from gains in the Equity Investments business and minor assumption changes within Insurance. When you exclude these elements, whilst lockdown restrictions continue to impact, we are nonetheless seeing some very early signs of recovery in the second quarter. Retail, for example, delivered slightly higher levels of activity-led other income in Q2. Likewise, Insurance and Wealth new business saw a modest improvement in the quarter, particularly in workplace pensions and particularly on a volume basis compared to the prior year.

Commercial Banking meanwhile was broadly in line with Q1, despite slightly softer Markets-related income.

Looking forward, we do not assume the same level of Equities and Insurance gains. But we do expect underlying other income to gradually recover in the second half of the year, supported by increasing activity levels. We will also continue to invest organically in income diversification opportunities which produce income over the medium term.

I will now look at costs on slide 14. Our market-leading cost:income ratio of 54.9 per cent continues to provide competitive advantage and remains fundamental to our business model.

Operating costs for the half came in at £3.7 billion. This is slightly higher than last year, reflecting the accelerated rebuild of variable pay given the stronger-than-expected financial performance in income and impairments. Our focus on efficiency and cost discipline is unchanged and enables continued investment in the long-term success of the business.

Looking forward, we now expect 2021 operating costs to be circa £7.6 billion. This increase from previous guidance takes into account the variable pay adjustment. Excluding the impact of variable pay, operating costs are developing as expected at the start of the year. Remediation of £425 million includes £91 million in respect of the regulatory fine for historical insurance renewals, £150 million for operating costs and redress for HBOS Reading, as well as charges in relation to other ongoing legacy programmes.

On HBOS Reading, we have now had the first few decisions from the independent panel re-review. As disclosed previously, there could be further significant charges in coming periods, albeit the exact timing and flow of these is uncertain. These remediation charges are clearly very disappointing, but we are working hard to make things right and to put these issues behind us.

Now turning to slide 15 to look at impairments. Asset quality remains strong and new to arrears remain low. While we continue to expect some deterioration, consistent with our macroeconomic forecast, underlying charges are currently below pre-Covid levels. In this context, Commercial Banking has also benefitted from improved restructuring outcomes and lower balances. The net impairment credit of £656 million in the half is bolstered by an £837 million release relating to our improved economic outlook. We believe our economic assumptions remain prudent compared to market expectations.

As a result of these changes, our stock of ECLs has reduced to £5.6 billion. We are still around £1.4 billion above the closing 2019 level and we have also retained our Covid-related management judgements. Indeed, these have increased in the second quarter to £1.2 billion, including the £400 million central overlay we took in Q4 2020, relating to the significant uncertainty in the current environment. Covid-related management judgements also include circa £800 million held in Retail and Commercial, largely recognising the potential delay in losses that we would have expected to see had support schemes not been in place during the pandemic. Given the asset quality environment and improvements to our economic assumptions, we now expect the full year asset quality ratio to be below 10 basis points. Needless to say, uncertainty remains on the outlook.

Now turning to the next slide to look briefly at credit quality within Retail. The Group has a high-quality mortgage book, which continues to improve. The average LTV is now 43.1 per cent and 94 per cent of the book has an LTV of 80 per cent or below. Our pre-2009 book is now £46 billion and has an average LTV below the wider book, at 39.2 per cent. As you can see, new to arrears remain low across our retail portfolios, at or below pre-crisis levels. This is despite over 99 per cent of payment holidays having expired.

Moving to Commercial on slide 17. We have a high-quality commercial portfolio with around 70 per cent of exposures at investment grade. New to BSU cases are below pre-pandemic levels and currently falling.

Exposure to the sectors most impacted by coronavirus has reduced by £2 billion over the last year and is around 2 per cent of Group lending. I note in this context that we have removed Oil and Gas from the chart as we can no longer justify calling it an impacted sector. As you can see on the slide, there has been a significant reduction in Commercial Stage 2 balances in the first half of 2021, from £14.3 billion to £8.4 billion. This is almost entirely within the up-to-date portfolio and is predominantly model-driven, given our improved macroeconomic outlook. Stage 3 balances remain low and have reduced by £0.4 billion in the half.

Our Commercial Real Estate portfolio focuses on lower-risk property segments and has been substantially de-risked and secured. Further risk mitigation is achieved through significant risk transfers.

I will now turn to statutory profit on slide 18. Statutory profit after tax of £3.9 billion and the return on tangible equity of 19.2 per cent for the half were both significantly ahead of prior year. These benefitted from higher underlying profit, lower below the line items and the tax credit in Q2.

Looking at the individual below the line items. Restructuring costs of £255 million are significantly up on prior year and reflect the previously-signalled higher levels of spend in technology R&D and in severance. We should see the benefits of this investment in our technology stack and financial performance over coming years. We have previously talked about restructuring being higher in 2021 than in 2020 and that remains our expectation. The run rate is therefore expected to pick up in H2.

Volatility and other items was favourable for the first half, benefitting from around £250 million of market gains within banking and insurance volatility.

Following the enactment of the increase in corporation tax to 25 per cent from 2023, we recognised a P&L tax credit of circa £1 billion, relating to the revaluation of our deferred tax asset.

As you know, the tax credit does not impact capital, but it is impacting profits and returns. Given the improved outlook for both NIM and AQR, and the updated operating cost guidance, we now expect the 2021 full year RoTE to be circa 10 per cent. This excludes the circa 2.5 percentage point benefit from the tax credit just highlighted.

Now moving to RWAs on slide 19. Risk-weighted assets reduced £1.8 billion in the half, helped by continued optimisation in Commercial Banking, offsetting asset growth. We have also seen limited credit migration to date, in part due to the impact of house price increases. Looking forward, we now expect 2021 closing RWAs to be below £200 billion.

I have talked previously about regulatory RWA inflation starting on the 1st of January 2022 and it is worth spending a bit of time addressing the changes that we anticipate. We expect £12 to £15 billion of inflation relating to CRD 4 model changes and £3 to 5 billion relating to the Standardised Approach for Counterparty Credit Risk. In total therefore, we expect £15 to £20 billion of regulatory RWA inflation on the 1st of January. We will, of course, also see underlying customer-driven balance sheet growth in 2022. Meanwhile, we will continue with our programme of active RWA management over the course of next year. This will provide some offset, particularly through continuing to optimise the Commercial book.

Taking all of these points together, our expectation for 2022 closing RWAs is circa £210 billion. Again, I would highlight that uncertainties remain.

Looking briefly beyond 2022 on RWAs, the impact of Basel 3.1 in 2023 is expected to be broadly neutral. The reductions resulting from Foundation IRB changes are expected to offset increases across other areas. As disclosed previously, the full impact of Basel 3.1 will likely not be felt until 2028.

Turning to slide 20 and capital. Our CET1 ratio increased a net 50 basis points in the first half to 16.7 per cent. 93 basis points of capital build were partly offset by 37 basis points for dividend accruals and 6 basis points in respect of the revised software rules.

As mentioned previously, the CET1 ratio includes circa 50 basis points from the change in treatment of software intangibles. The PRA have stated that they will repeal the revised treatment on the 1st of January 2022. CET1 also benefits from 78 basis points of IFRS 9 transitional relief. We expect this to run down over the rest of this year and the early part of 2022, linked to macroeconomic developments and the model changes on the 1st of January 2022.

Excluding the impact of both the software intangibles and all of the transitional relief, our CET1 ratio would be 15.5 per cent. This is still significantly ahead of our ongoing capital target of circa 12.5 per cent plus a management buffer of circa 1 per cent, as well as our regulatory capital requirement of circa 11 per cent.

Following the regulator lifting restrictions on banks paying dividends, our strong capital position has enabled the Board to announce an interim ordinary dividend of 0.67 pence per share. The Board’s commitment to capital returns remains unchanged.

Our interim dividend reintroduces a progressive and sustainable ordinary dividend policy, with payments to be made twice per year. Any decisions about surplus capital distributions, as usual, will be taken by the Board at the full year.

Looking forward, in addition to BAU capital evolution, we expect the acquisition of Embark in Q4 to consume circa 30 basis points on completion, from a combination of price and restructuring and integration charges.

So, finally, moving to slide 21. To summarise, we have supported our customers throughout the pandemic and we remain absolutely committed to Helping Britain Recover.

In the first half of 2021 we delivered good progress against our strategic priorities, continued business momentum and a solid financial performance. We have a strong capital position, with a CET1 ratio of 16.7 per cent, after an interim dividend of 0.67 pence per share.

The Group's solid financial performance in the first half, as well as the improved macroeconomic assumptions, enable us to enhance the Group's 2021 guidance. We now expect:

- The net interest margin to be around 250 basis points;
- Operating costs to be circa £7.6 billion;
- The net asset quality ratio to be below 10 basis points;
- The return on tangible equity to be circa 10 per cent, excluding the circa 2.5 percentage points benefit from the change in tax rate; and
- Risk-weighted assets to be below £200 billion.

In the medium term we continue to target a return on tangible equity in excess of our cost of equity.

In sum, although the economic outlook remains uncertain, the Group's business model and financial strength will ensure that it can continue to support its customers and to Help Britain Recover. This is fully aligned with the Group's long term strategic objectives, the position of the franchise and the interests of our shareholders.

Before closing, I would like to say that it has been my honour to be the Interim Chief Executive over the last three months. I am immensely proud of everything the Group has done to support our customers and colleagues, whilst Helping Britain Recover in these unique and challenging times. I very much look forward to working with Charlie when he joins in August.

That concludes my remarks today. Thank you for listening, Jon and I are now available to take your questions. Thank you.

Question and Answer Session

William Chalmers, Interim Group Chief Executive

Question 1 – Joseph Dickerson, Jefferies
Good morning and a good set of numbers there. Just on the Covid management adjustment of £1.2 billion, what hurdles do you need to see to release that, and is that something that you wouldn't expect to hold into 2022? And how would you put that to use if you were able to release that, in terms of what would you prioritise? Thanks.

William Chalmers
Thank you Joe. The Covid-related management judgements, as you know, in total comes to £1.2 billion. That is a combination of the £400 million overlay that we put in place essentially as insurance on the conditioning assumptions around our multiple economic scenarios. And then £800 million of further adjustment relating to retail and commercial book. In sum, all of those adjustments, the entire £1.2 billion, are essentially related to judgements that we have taken to address potential shortfalls in the impairments that we would have seen but for the Government policies that have been in place, number one, for the £800 million. And for the £400 million overlay, as you know, this is essentially conditioning insurance against our base case assumptions proving wrong. Whether that is in relation to the vaccine rollout, virus mutation or how unemployment adjusts in the post furlough period.

So, in answer to your question, what we would be looking for in order to roll off those management judgements is essentially development in those factors. So as the vaccine rollout completes, number one; as we see further evidence of virus mutation or hopefully not, number two; as we see unemployment adjusting off the back of furlough changes in line with our expectations, number three. Those factors will go to give us greater assurance in terms of the £400 million overlay. And then in terms of the

£800 million other factors, we will see as to whether or not the losses that we have accounted for in the context of those Government support mechanisms actually transpire as the economy develops in the backend of 2021, going into 2022.

So I think those are the types of catalysts that will cause us to look at the management adjustments, Joe. I think most likely that takes place throughout the second half of 2021. It is quite possible that it rolls into 2022, but that is very contingent upon all of the factors I have just mentioned. We will look to be prudent as we address those issues going forward.

In relation to what we would use that for, a couple of points just worth bearing in mind. One is to the extent that those management judgements are accounted for by essentially stage one and stage two ECL, then essentially they are accounted for in the transitionals that we have in the capital ratio right now. And so as some of those management judgements come off against stage one and stage two ECLs, we are effectively de-risking our capital structure and removing a potential future drag on our capital structure as we look forward. So the capital position looks stronger for it, but it is because transitionals just get solidified in the capital base.

Clearly, to the extent they are due to write-backs in stage three loan provisioning, then indeed that comes back onto the balance sheet as incremental capital, and that then strengthens the capital position above and beyond what we already have.

In terms of our priorities as to how we would look to deploy that additional capital, as ever we remain very committed as a Board to capital returns to shareholders. We also remain committed to continuing to invest in the business in the right way to ensure its prosperity going forward.

So hopefully that is helpful to your question, Joe.

Joseph Dickinson
Yes, thanks William.

Question 2 - Raul Sinha, JP Morgan
Good morning everybody. A few from my side. The first one on capital. I just wanted to get a sense on what the Board would look at when it comes to making the decision around payout. And by this I mean, what CET1 ratio will you be looking at, at the full year? Should we think about 16.7 per cent, excluding the IFRS9 transitional relief and excluding software as the right ballpark capital number, or are you going to proforma for the regulatory changes? And the reason I ask that is also because I am wondering whether the previous historical approach of paying all of your capital out, above the right CET1 number, is still valid, in the current context. Interested in any thoughts you have on that.

And then maybe a follow-up on your comment around non-NII - you highlighted that there were a few one-offs this quarter and you reiterated that you expected a gradual recovery in the second half. Can I check whether you expect that sort of base level to still be the £1.1 billion type of run rate that you talked about previously, referencing the gradual recovery? Or should we think it is more like £1.2 billion in terms of what we should be building on?

William Chalmers
Thank you Raul. To address each of your questions in turn. First point is just to reiterate the fact the Board remains committed to capital return just as it has always been. There is really no change there. And hopefully today's statement of the interim dividend off the back of the change in PRA guidance is confirmation of that. It does, as you say, come off the back of a very strong capital position. And 16.7 per cent as I mentioned in my comments earlier on is unequivocally well ahead of both our regulatory capital requirements and indeed our own internal capital policy.

Now looking forward to the considerations that we will take into account for any distribution of excess capital at the end of the year, it will be the usual factors. Our capital position, the macro outlook, regulatory factors, investment in the business, and so forth. The usual parameters.

You asked what is the relevant capital ratio to look at in making that consideration. And I think, as you say, you could take the 16.7 per cent as it stands today. If you make as it stands today adjustments, I think you would be right to look at software adjustment, we anticipate that coming off as of the 1 January 2022, which is circa 50 basis points or thereabouts. You could also look at transitionals. The source of transitionals as they roll off over coming periods is the combined effect of the development or the evolution of the macroeconomic forecasts that we have, and the expectations for asset quality in that environment, number one. And also to a degree, model adjustments that we will see on 1 January next year, number two. There are some mechanics within that that give rise to effectively costing some elements of the transitionals.

You could take a relatively prudent approach and say, right, I will just take that transitional block out, which is 78 basis points today, as you know. I would just bear in mind that the experience so far has been a little bit better than our expectations. We have to see clearly how that rolls off over the second half. But it is possible, in line with the comments made to Joe earlier on, that some element of that transitionals does not roll off in exactly the way that we expect. Credit quality turns out to be a bit better than we expect and so some of those transitionals effectively just solidify back into the capital base.

Then I think Raul we have to see how things develop. You can see our guidance that we have given today, you can see our macroeconomics we have given today. And that is our best shot as we stand today.

Now when we look at the target at the end of the year, one point that is apparent is that the RWA density in the business is increasing, and inevitably that causes us to think about what does that mean for our overall capital position within the business. Right now we very much stick with it and stand by our 13.5 per cent total which as you know is 12.5 per cent core plus a 1 per cent management buffer. That is predicated upon stress analysis of the capital base of the business. As that stress analysis stays the same but regulatory RWA density increases, we obviously have to think about that, but that is not for today, that is for the end of the year.

The second question you mentioned on OOI. As you say, the OOI development over the course of the quarter have been positive. We have seen £1.28 billion in Q2 OOI which, as you say, is positive on Q1, composed of two main elements. One is just under £100 million of benefits from our equity-related businesses, and also a minor element of insurance assumption changes. You can potentially strip that out. But what we have also seen, which is encouraging, is some resumption of activity in Retail, particularly interchange, and in Insurance, things like workplace, things like protection and so forth. And so the activity accounts for the remainder of the uplift in OOI in Q2. We do think that this is predicated on less than a quarter of full reopening. And so if and as we see a fuller reopening going forward and consumers being a bit less cautious than they have been, there is potentially more to go for in that activity-led recovery. And that is consistent with the £350-400m cost that I have mentioned in the past over the course of three quarters of lockdown, that we saw in 2020. So I think organically, you will get that rebuild, and to your point, I wouldn't want to be too precise about a number, but it does look like the run-rate is moving up from £1.1bn to something that is more like £1.2bn. As I said, it may be that there is a little bit more to go for, we have to see how the economy reopens.

And then I think on top of that, as I said before, you get the gradual benefits of the organic investments that we have been making on this. Final point Raul is that as ever OOIs is going to be activity-dependent. The signs so far in Q2 have been constructive. We would certainly look forward to more of that as the economy reopens. But again that activity dependency is really the key.

Raul Sinha
I apologise but I think you cut out slightly in the answer to the capital question. So just to paraphrase and make sure I understand correctly - not all of the transitionals should be adjusted out, some of them might solidify. And then in your 13.5 per cent ratio, given the increase in RWA density, you will take a closer look at what the proxy ratio is for the Group as well at full year?

William Chalmers
Just to retrace. On the transitionals, the point I was making is that you can look at our capital position, which is very strong today at 16.7 per cent, and you can take a view that you want to strip out software, which makes sense to me because the PRA is going to strip it out on 1 January next year anyway. And you could look at the transitionals which as you know are 78 basis points currently, composed partly of dynamic, partly of static. And you could choose to take those out. And again, that would be fair enough. The move of transitionals is driven by a combination of macroeconomic evolution of the asset book plus also 1 January 2023 RWA changes, which impact on transitionals.

My only word of slight caution there is that macroeconomics have so far this year turned out a little bit better than we had expected, and therefore if that continues to happen, some elements of the transitionals that previously have covered Stage 3 movements in our asset base - Stage 1 to 3 movements in our asset base - we will not recover that because that evolution doesn't take place. Instead, those transitionals stay on the balance sheet in the capital ratio, and effectively de-risk the capital ratio and remove the source of drag going forward. Whether that happens or not is really dependent on your view of how the macroeconomics unfolds in the second half of this year. We have given you our view of our macroeconomics, but everybody has their own view on that topic. So that is our view on that point.

On the capital levels, I was simply making the point that we are very much sticking with our 13.5 per cent which consists of 12.5 per cent plus, as you know, a buffer of 1 per cent. At the same time, one of the factors in that capital level is stress performance of the business. That stress performance has not changed despite the fact that we are seeing an increased RWA density off the back of a change in January of next year. We stick with our capital targets for the time being, but we acknowledge that this point is going on in the background which is clearly an interesting development.

Raul Sinha
Thank you very much. Very clear.

Question 3 – Ben Toms, RBC
Good morning, thank you for taking my questions. Just firstly on Embark, the purchase plugs a gap in the bank's mass market Wealth proposition. Are there any other gaps in your Wealth proposition that you think need particular enhancing, and how worried are you about Goldman Sachs and JP Morgan moving into the space with Marcus and Nutmeg?

And secondly, there has been some recent press on Lloyds entering the real estate market, can you give us an idea on how big a part of the Lloyds Group this business could eventually become? Thank you.

William Chalmers
Thank you, Benjamin. Three questions in there. So perhaps to take them in order. The first point is that we are obviously very excited about the acquisition of Embark today. It does, as we see it, complete the waterfront of our wealth offering. So if you look at our wealth offering right now, it is composed of three main components. One is the acquisition of Embark today, which is aimed at mass market and self-directed consumers, as well as enhancing also our intermediary proposition. I will come back to that in a second. Two is, for those that prefer advice, the Schroders Personal Wealth offering is in place. And three is, in relation to high net worth customers, we have the investment in Cazenove that we have. So what we have is a very complementary wealth offering which we see as now being a complete waterfront. We have been working with Embark a long time to secure this acquisition. We are tremendously pleased that we have managed to announce it today. We very much look forward to working with the Embark team going forward. What it is going to do is a significant addition to our wealth and retirement proposition. And what I mean by that is that it gives us a direct-to-consumer capability on what is a modern platform for a spectrum of consumer savings products. It also gives us an ability to integrate and modernise HSDL, alongside our execution platform. Thirdly, again, it gives us a platform on modern technology - FNZ technology - to transform our retirement account, drawdown and indeed our accumulation proposition.

And then finally it gives us an interesting B2B white label business in the savings platform area. So it is a tremendous proposition which sits in a very complementary fashion to our existing Wealth offering. The reason why are so excited about it is because this is a huge opportunity. We think that over £10 billion of assets under management every year leave our Lloyds customer base to go and be managed by other providers. There is no reason why that should be the case. We should be able to offer a compelling proposition to our savers going forward, across our entire customer base. And indeed, that is what Embark is going to allow us to do, in a complementary fashion to Schroders Personal Wealth and of course, the Cazenove interest.

So for now, Benjamin, our wealth offering is very complete. We see it as compelling across the waterfront and we are really excited about what we can do with Embark going forward.

You asked about JPM and Goldman Sachs. I think we have to let competitors do whatever it is that competitors are going to do. The only point that I would make is that the fact that they are interested in operating in the UK market, I think just underlines that it is an attractive market and it is a market that we really believe in. We were here yesterday, we are here today, we are going to be here tomorrow. We are a longstanding feature of this market. And whatever the competition from outside of the UK brings in, we will address that as it comes.

The third of your questions venturing around the Citra initiatives that we have. A couple of points to make there. One is the work that we are doing in respect to Citra, to address what we consider to be a relatively poorly served market with a lot of private landlords that are mainly withdrawing, and a market where we believe we can really help customers. The area of housing and any risks associated with that is an area of significant expertise for us, clearly. And so we see this as an ability to leverage off of many of our core competencies. It is also somewhat adjacent to our other business areas. That is, the generation of long-term assets is obviously interesting to us from our insurance perspective as well. So there is a degree of complementarity there. And what it gives us furthermore, is the opportunity for a really holistic customer offering. Where we can offer a customer a high quality rental proposition, potentially at least there is also a customer who may be interested depending on their circumstances, in insurance, in personal credit, in mortgages. And so we see this as very adjacent to our core areas of expertise.

But I would say Benjamin, that underlying all of this is a very disciplined approach. We are keeping this on a limited basis while we explore the area, while we allow ourselves to learn from it. And as I say we will take a very prudent and appropriate approach to gradually exploring this area further, in line with the objectives that I have just laid out.

Ben Toms
Thank you.

Question 4 – Robert Noble, Deutsche Bank
Morning. Can I ask a couple of questions. The first one is on costs. I think within your original £7.5bn guidance you had already assumed an increase in performance costs. Is the new £7.6bn guidance assuming that performance costs exceed 2019 levels, or what is in there for performance costs?

And then secondly, there has been a big uplift in commercial banking gross margins and group margins as well. Could you give us a bit of a breakdown between the margins on SME, mid-corporates etc and how you think about the margin of that business in particular going forward, so that we can filter it into the Group? Thanks.

William Chalmers
Thank you Rob. First of all, your question on costs. Just to restate the point at the outset that costs remain a core area of focus for us and indeed a core source of competitive advantage. Our discipline very much remains and you can see that evidenced in the cost:income ratio that we have, which continues to be market leading. We did increase costs during the half relative to last year because of the increase in variable compensation. And as I mentioned in my comments, including this, everything else is on track whether that is property, whether that is IT, whether that is operations, whether that is in marketing. Now as you rightly point out Rob, much of the increase in variable pay is actually already in the £7.5bn guidance that we gave at the beginning of the year. You are absolutely right in that respect. What we have done today is to acknowledge the fact that income developments are proceeding faster and better than we expected. Likewise, impairments developments. And that then causes us to look at that variable pay and to accelerate some of the rebuild that we have previously built into future years. So essentially, what you are seeing today is just a bring forward - because of the better income and impairments performance - of that increase in variable pay, that otherwise would have taken place during the course of 2022/23, obviously depending on the development of the P&L during those periods.

So hopefully that helps you in terms of the understanding in that area. But again just to underline that this area remains key and a core component of our competitive advantage. The focus is not lost. We do want to recognise colleagues, given the fact that we paid no bonus last year, we want to recognise to colleagues that things are proceeding in a better way than we had expected, and therefore it is appropriate to enable our colleagues to share in that performance.

On the Commercial Banking margin that you mentioned, you can see that as part of the overall Group margin that we have given. And the overall Group margin basically showed 250bps in the first half. We are giving guidance for 250bps across the year. And so you can see that our expectations for the second half of the year are pretty much in line. So a steady picture for margins during the course of the second half.

As for the particularities of the Commercial Bank margin, there are a number of different moving pieces that are going on in there. One is optimisation which is a positive, or upward pressure, for the Commercial Banking margin. And that is off the back of the way in which we approach our customer relationships; the way in which we select assets that we invest in or don't invest in; the way in which we manage the balance sheet in connection with our RWA activities. A number of different factors. But that optimisation process contributes to a better Commercial Banking margin than would otherwise be the case if we did nothing.

The other elements that are at play here are developments in terms of the organic lending picture, which as you can see, has been relatively static over the course of the half. Frankly, that reflects a commercial market that is pretty flush with cash, and therefore not necessarily needing to take out new lending facilities in quite the way they might normally do. We will see whether the recovery changes that over the course of the remainder of 2021 and indeed going forward.

And then thirdly, the composition of Government lending in that picture which at the moment is pretty much in line with what we have seen before, but we are now starting to enter the repayment periods of things like bounce back loans for example. Overall that is just one of three components, but it is notable.

That is the asset side. If I flip over to the liability side, you can see that our funding costs have come down over the course of the half. That is reflecting a very liquid balance sheet. That in turn helps the Commercial Bank margin. And that is a further factor playing into the equation, Rob.

Robert Noble
Thanks. Can I just quickly follow up on your cost point. So I hadn't fully appreciated that you accelerated the performance from the 2022-23 years. Presumably if I look at consensus, if impairments normalise higher, than the performance costs will come down in 2022, and provide some offset there. Is that how I should think about it?

William Chalmers
Well, essentially the variable pay component, Rob, is simply a reflection of the P&L development that we have seen. So that hopefully explains your question. If impairments come down next year, that is clearly a better financial performance for the business, and we would obviously look at variable pay in that context. I am not sure whether that answers your question, but hopefully it does.

Jon Burgess
And William, there is an element of those costs that are deferred across into 2022 relating to this year's pay as well. So you won't get that sort of fluctuation that you are pointing towards.

Robert Noble
Right, thank you very much.

Question 5 – Omar Keenan, Credit Suisse
Good morning. Thank you very much for taking my questions. I have just got two. So firstly on consumer credit. I can see thanks to the slides that credit and debit card spending are above pre-pandemic levels. I was hoping you could help us think a little bit more about credit card spend and how that is evolving, as well as payment rates, and how those two factors are balancing to influence the development in interest earning balances in the credit card book? And perhaps what observation that you are making around the behaviour of the UK consumer as we are moving through the re-opening and what one might say about whether they will return to more normal patterns of behaviour?

And my second question is just on mortgages. I was wondering if you could give us a little bit of colour perhaps on where completion and application margins were over the second quarter, and perhaps where application margins are in July if possible? Thank you.

William Chalmers
Thanks very much Omar for that. Perhaps just to kick off on the consumer behaviour and one or two points on spend data. As you rightly point out, total spend is strengthening, without a doubt. And if you add up debit and credit card, it is ahead of 2019, as we stand today. But within that, credit card spend, to give you some idea, it is down about 7 per cent in June 2021 versus June 2019. So credit card spend is still a little way behind, albeit it is strengthening. Within that credit card spend, you have got a couple of different components. Retail is strong. Entertainment, not surprisingly, is coming back. But still there is a significant drag in terms of travel, again not surprisingly, versus what you might have seen in the equivalent period of 2019. And it is that which is the big driver of credit card balances in particular going forward. We are also as you say seeing increasing numbers of transactors as we call them, and fewer are revolvers. And that is what is leading to the higher repayment levels in terms of credit card balances. So there might be a transaction on the credit card, but it is repaid more quickly.

Now inevitably as we go forward into the opening up period, we will see more purchases of consumer durables, we will see more travel. And it is travel in particular which is, by way of example, around 30 per cent of our credit card spend. So it is a big contributor to credit card spend. And as we see that travel unlock, so we would expect to see credit card spend start to rebuild. Now we are expecting a degree of caution to remain within the consumer outlook and consumer behaviour. So it is interesting that we have seen what may well be an inflection point in card balances in Q2; they have been pretty stable through the course of Q2. And we do believe, and we mentioned in my script earlier on today, that we do believe that we will see a modest bounce back in terms of card balances going into second half of 2021. How fast that is will clearly depend upon levels of activity, in particular things like travel spend as I just mentioned, and one or two other related areas. We are being relatively cautious in terms of what we expect to see. We do expect to see a rebound, we do expect to see a rebuild. But perhaps still a little bit shy of year end 2020 levels, but again activity-dependent.

On your second question on mortgage margins, as you know, the market was very attractive during the course of the first half. We were very pleased to play such an important role in meeting customer ambitions and demands in the post-pandemic period, and expressing their housing preferences. And you would have seen in our first half we did £12.6 billion of volume, and in the second quarter, we did £6.6 billion. So it was really a very strong market. And during that time we had frankly very attractive margins. During the course of the second quarter, they came down a little bit, we were at 175bps completion margin in quarter two versus quarter one of 190bps. So you have seen some reduction. But that 175bps is still compared to a maturity out, i.e. in the asset that it is replacing, of 133bps. So you have still got a very positive development in terms of that turnover.

Now as to applications today, they continue to come down. We are still at the point where pricing within the mortgage business is still well ahead of Q1 20, the pre-pandemic period. But there is no doubt that there is increased levels of competition on that front-end pricing. And we would expect that to continue during the course of Q3. So as an approach, we will retain our discipline in terms of our participation in that market. The mortgage market remains very attractive, built upon attractive margins right now. We are seeing further competition and we will tailor our approach accordingly over the course of the second half.

Omar Keenan
Thank you very much.

Question 6 – Alvaro Serrano, Morgan Stanley
Good morning. I have a couple of follow-up questions on capital please. William, you mentioned that you could have a look at your 13.5 per cent target. Obviously the stress in RWAs are going up, implying it could be somewhat lower. But if we look at the stress test from the PRA, they saw a larger draw down of capital, can you maybe speak to that and is that a risk that we learn in the full year when we get the buyback detail, that there is another nudge in terms of capital that you are required to hold - is that a risk to that potential lowering of the target?

And second, when we think about the Board discussions that might happen in February around the potential for distribution, obviously you have mentioned that they will think about potential headwinds. My question was on Basel 3.1. Can you maybe talk to the sequencing, you mentioned that the peak impact is going to be 2028. But obviously you are looking for reductions in the IRB models. Can you speak to the sequencing there - are you going to see a benefit initially, and will the Board take that into account? Just talk us through that if you can. Thank you.

William Chambers
Sorry Alvaro your second question there, I just want to make sure I followed, would you mind just briefly repeating that?

Alvaro Serrano
Yes, so on the Basel 3.1, you mentioned that it is neutral now, and the peak impact would be in 2028, you mentioned I think in your script. But initially you will have presumably some IRB changes that you are also flagging. So I just want to understand what is the feeling on those impacts and to the extent the Board might take into account when they decide about distribution in February?

William Chalmers
Yeah that is fine, thank you. So I think your first question in terms of the stress tests. As you say the stress tests will be disclosed by the PRA at the end of the year and that will be on a bank-by-bank basis. We are obviously participating in the collective, aggregate stress tests right now. And I can't disclose anything more about that. But I think overall we would expect to be strong enough to withstand stress pressures and to continue lending into the economy, which is the key policy objective that I think people would like to see us achieve. We have to see how that evolves.

But I think in the context of our overall capital targets, our capital targets will take into account a whole range of things. And as we look at them both today and at the end of the year, there are a number of factors that play into that. I mentioned risk weighted asset density as one example. But it is obviously also things like the macroeconomic outlook, the performance of the business against stress, taking into account any regulatory variations, the uncertainties that there might be in terms of the pandemic environment, for example. There are a number of factors that will play into that. Our capital target today is 13.5 per cent, based upon the 12.5 per cent plus term buffer. That remains the case. There are a number of factors that, as always, we will look at in the context of capital targets going forward.

The Basel 3.1 question that you mentioned, we talked in quite a bit of detail around the effects of the regulatory RWA inflation on 1 January 2022, and hopefully I have given enough information on that or if not please do ask. But what is also interesting is as we move forward into 2023 there is a further capital development described in Basel 3.1 as you say. And as you pointed out, in my script I mentioned that there is no material impact from that, and the reason for that, for us at least, is because at the moment we are operating off Foundation IRB standards. And so when we get to Basel 3.1, the changes in the capital regime convey some benefits for those banks that are on Foundation IRB. It is things like a reduced scalar in the risk weighted asset calculation, a reduced credit conversion factor for undrawn facilities, it is things like reduced loss given defaults. Now for sure there are some headwinds, the removal of the corporate exemption for CVA is one example, revised standardised operating risk is another example. There is a debate right now about whether or not the SME scalar should be removed, as a third example. So there are some headwinds in the context of the 2023 Basel 3.1 introduction. But for us, because we are on Foundation IRB, the benefits at least accommodate those headwinds. And so as a result, we are calling it neutral at the moment, recognising that there is a bit of uncertainty in this area. We do expect more clarity from PRA in Q4 of this year. But for now, we are calling it a neutral.

Alvaro Serrano
So just a quick follow-up to summarise, if I got it wrong, but at the moment if you take out the software you are at 16.2 per cent, and the headwinds, certainly the RWAs in 2022 are lower, and there is not much more inflation to go beyond that. So, with the current asset quality outlook, that is pretty much all distributable down to 13.5 per cent or even below? Is it all distributable and investable if you do more acquisitions? Am I missing something very obvious or can we happily assume that is all available?

William Chalmers
No, I don't think you are missing anything obvious in terms of the inputs, Alvaro. We have the capital position as stated today, 16.7 per cent. I think as discussed earlier on, you can take a view on software, you can take a view on transitionals. I do think that you need to look at the 1 January 2022 RWA inflation. And recognise that comes early in the year, and then we have the organic build of capital, assuming normal operating conditions over the course of next year, which then offsets that, clearly. And we then get the dynamic that I described in 2023, off the back of Basel 3.1. So I think that those are all the inputs. And then in terms of the decisions around what to do with excess capital if we see it like that at the end of the year, it does revolve around the regular standard processes that we go through towards the end of the year. And that will include the macro, the outlook, the investments for the business. Usual stuff really, nothing changes.

Alvaro Serrano
Thank you very much.

Question 7 – Andrew Coombs, Citi
I think my question has been answered, but a few clarifications. Firstly, I think in answer to Omar's question on the mortgage margin, we've come from 190bps to 175bps in Q2, with current application run-rates lower than this but still above where they were a year ago. I don't think you provided any number. Could you possibly just provide us with the number on where the current application margins are?

Question two is just calculation of dividend. If I look at the accrual you put through in capital, and annualise it, what does it mean for dividends for full year? And then can you clarify what your definition of progressive dividends mean? Thank you.

William Chalmers
Thank you Andrew. In response to your first question. I said Q1 completion margin of 190bps, Q2 more like 175bps. As I said, those are still both very favourable and actually quite similar simply because of the back book distribution benefits to the asset that rolls off, that they replace. We haven't given a number for current applications, and the reason for that is because it moves around quite a lot, and so therefore, we are seeing increased competition in the market, that is a trend that we expect to play out during the course of Q3. Hopefully the direction therefore is clear, but I am not giving precise numbers simply because they move frequently.

On the second question, dividend accrual. We are asked to accrue, effectively, for all foreseeable dividends as indeed for any foreseeable capital outflow. And so you will see the 37 basis points that we have accrued for dividends there, and you can obviously work out from that what you think it might imply as to the statement around where we think the full year dividends might be going. But that is clearly contingent upon the Board discussion at that time in the second half of this year. And I will leave you to figure out the numbers and where you think the Board might end up on that topic.

The progressive point is a good question. What we have done today is to recognise the importance of capital return to shareholders. That is unequivocal. We have described the dividend as progressive and sustainable, and that is a commitment going forward. And what we have done is essentially set the dividend at a level that allows us to put forward an attractive income, but also a progressive and sustainable growth going forward, allowing for whatever macro uncertainties there might be out there. And so we are focused not just on the dividend today but we are also focused on creating room for the dividend to grow in a positive way going forward, and that is part of our considerations too. So I won't put a number on it, Andrew. I don't want to be too tightly defined. But we are conscious of wanting to grow this dividend going forward.

Andrew Coombs
Thank you. Just quickly coming back to your point on the current application margins. I guess if I look at your current pricing across your product range, be it 2 year, 3 year, 5 year, various range of LTVs, rates have come down by 25 bps over the last month or couple of months. If you add that in with where you have seen the forward spreads go, it looks like you have been looking at quite a big drop from 175bps in Q2 down to Q3. Can you just confirm that you are comfortable that you are still writing business above the 133bps that you mentioned?

William Chalmers
I can tell you Andrew that we are comfortable with a solid pipeline of mortgage lending that we have for Q3 right now. That is based upon pricing which by definition, we see as attractive. And so, again I won't put numbers on in terms of new applications, but by implication hopefully you get there to reach the conclusion that you just reached in your question.

Andrew Coombs
Thank you.

Question 8 – Aman Rakkar, Barclays
Morning William. I have a couple of questions on growth and some on consumer credit. The first one is around your medium term appetite for growth in the business. I know you guys haven't filed the ring-fenced bank report right now, but I suspect you are growing your ring fenced bank above the next systemic buffer capital charge. So I guess if that was to happen, which presumably given the mortgages, the consumer credit opportunities out there, if that was to tip you into a higher systemic capital charge in the ring-fenced bank, could that have any implications for the group's CETI ratio? Obviously I note that alongside the commentary about the lower stress drawdown. So that would be the first part of the question.

And secondly and related to that, is what does this potentially signal about your growth ambitions for the business? Presumably if you do tip into that higher systemic charge are you kind of incentivised to continue growing now, and should we expect your balance sheet to continue growing through 2022 and beyond?

And a third related question to that is particularly the corporate loan book, it does look like you are looking to do quite a lot of optimisation on that business next year to offset the regulatory RWA inflation. What does that mean, net net, for net commercial loan growth? So can you grow that book in 2022 or actually is there too much optimisation and Government guaranteed refinancing taking place underneath that, that is going weigh on that?

And just a final question around car finance. I was actually kind of surprised to see that take a step backwards in Q2. Just kind of interested in what you are seeing there and to what extent does that relate to a supply bottleneck? It looks interesting, particularly alongside the appreciation of second hand car prices that we are seeing. It is obviously good for operating lease depreciation, but when can we expect that car finance book to start growing?

William Chalmers
Yeah thanks. On the first of your three questions, growth RFB thresholds. It is a good question. I guess the start point is that while we are clearly building the business, we are still below the £610 billion cap that is relevant to the OSII charge in respect of the ring fenced bank. So we are still operating within the levels of assets that is consistent with our current OSII charge at a RFB and ultimately therefore at a Group level. If we were to exceed that level, then it would add on a further 50bps of capital to the RFB, which in turn then plays itself through into a slightly lesser form obviously, in a proportionate form to the Group capital charge. So that is the consequence of moving beyond.

Now where we are today is partly a function of growth activity on the asset side of the balance sheet, and hopefully that continues in the context of a recovery. But it is also a function of a very liquid environment, and partly a function of the growth in deposits that we have seen, £63 billion since the beginning of 2020. And so that allows us to potentially manage the balance sheet in a sensible way going forward to stay within the £610 billion cap, if that is what we choose to do. If indeed we were to ever take that decision to go beyond 610, it would be in the context of growth within the business, and it would be in the context of income opportunities. And so, it would be, from our perspective at least, a value- added opportunity to go beyond that cap. Taking into account, as I said, that it would incur incremental capital for us on the OSII charge.

The other point that I would make there again is that we have a certain amount of slack before we get beyond that 610 cap and that is because the balance sheet right now is very liquid. And number two, even if we were to get an incremental charge, in the event that we went above that cap, we are clearly at a capital level that is in excess of our target capital requirements, however it is you measure them.

And so in answer to the question, it is an area that we are clearly keeping an eye on. We do have appetite for growth in the business, we do believe that this growth is consistent with our RFB cap. But if we were to go beyond it, it would be in the context of income realisation opportunities, and indeed, economic value-added opportunities going forward.

Second question, corporate loan book. The corporate loan book balance sheet development is a function of a number of different factors. But you referred specifically to optimisation and the role that that has. It is worth me just returning to that and spending a minute on it. The optimisation process is partly about low returning assets in areas of the book that don't make economic sense and so we obviously address that in the context of our client dialogues and see that as an opportunity to enhance the value of the balance sheet and indeed the business. It is also about capital-efficient securitisation choices. It is also about things like collateral management, and to a degree, also about re-rating of elements of the book. And so all of these things, and indeed, not just in the commercial business but across the business as a whole, are seen as a continual process of balance sheet management. It is not just about us doing it in 2021, and then that is kind of done. It is a process of continual management of the balance sheet. And frankly over time, we will look to get better at that. We believe that we can add value in the approach that we have in terms of serving customer needs, clearly, but also in terms of how we manage those customer needs in terms of the balance sheet. Obviously that applies, and most significantly applies, to commercial bank. But it is a proposition across the balance sheet and it is a continual process.

The third question is on car finance. What has been going on in the car finance market is a combination of a couple of different things. One is, as we said before, the change in approach to corporate fleets has led to Lex volumes falling, not just in this half, but it has been falling for a number of periods now. And that is just a difference in company car policy that you see playing out there. But in this quarter, what is also playing out, and I think what is behind your question, is that there has been a bit of a slowdown in dealerships restocking, that sort of thing, off the back of lower levels of new car supplies. And so as a result, the motor asset has been impacted by that. I think that resumes to back to normal levels potentially during the course of the second half, for sure during the course of 2022, as some of these pipeline clogs, not just in the car business but endemic to the economy, play their way out. So what you will get therefore is three factors that play out in the second half and go into 2022. One is the continued company car point I made around Lex a second ago. One is the unclogging of the pipelines around dealership stocking, returning to more normal levels. And one is potentially more enthusiastic recovery in the economy, which in turn builds motor demand. So I think all three of those things come to play. But I think what you see in the second quarter is particularly that dealership stocking point.

Aman Rakkar
Thanks William, you might not want to give too much guidance for 2022 and onwards, but it does sound like there is actually quite a lot of growth if I think about mortgages, consumer credit and maybe a bit less in corporate. But it does look like you should be able to carry on growing that balance sheet through next year?

William Chalmers
Well, we feel good about the business today. We think it has been a solid performance in Q1 and then again in Q2. The outlook as you can see from our economics has been improved. We believe that we are on the prudent side of general market consensus around that topic. Clearly activity and macro dependent, but we feel generally good about how the business progresses into the second half of 2021. And then we will see how the macro economy unfolds during the course of 2022. But you have seen our guidance improvement for the second half of this year, which hopefully gives you some insight.

Aman Rakkar
Thank you.

Question 9 – Jason Napier, UBS
Good morning, thank you for taking my questions. Two please. First, coming back to the issue of costs. I wondered whether we could approach it from a different perspective. It seems to me that the new guidance effectively requires you to keep the opex at the same level as 2Q for the next couple quarters and then pay the bank levy in the fourth quarter. So certainly not a runaway cost inflation story. I wonder whether you would talk about the investment spend last year and this year, and how the Board feels about investment in the platform, away from things like Embark, whether you are spending enough and how that looks?

And then secondly, just in reaction to some of the questions we were hearing from the market this morning, I wonder whether you might provide anything you could around the sort of scope of the Reading provisions, the colour around the opex versus findings split is helpful but I wonder whether you might give a sense as to how many of the cases have been adjudicated on or perhaps how it might impact capital returns in aggregate, either from a timing or scale perspective? Thanks very much.

William Chalmers
Thanks Jason. Two questions there. One on investment spend, one on developments in HBOS Reading. On investment spend, as you know Jason, investment spend cuts across all areas of our business, whether it is legal and regulatory as we term it, whether it is discretionary and aiming at income or cost opportunities. Investment spend cuts across them both. If you look at the investment spend for the business overall, over the course of last year, this year, and indeed, even actually the year before that, it is basically staying at the same relatively high levels. So we are still looking at levels of around £2.5, £2.6 billion of investment spend over these periods. Now within that, we are also, as you know, aiming to have just shy of a billion, about £900 million of strategic investment spend, and that has been roughly half during the course of H1, actually slightly less than half, just really for implementation-related reasons. So that is on track for the full year. So of the total investment spend that I just indicated, the £900 million or thereabouts of strategic investment spend is on track for the remainder of this year, and you will see that play out.

Related to that, you asked how the Board looks at the investment of the business. It is obviously critical for us to invest properly in the business to ensure the business is as successful going forward as it has been historically. And so, that is very much embedded in the Strategic Review 2021 ambitions that we laid out at the beginning of this year. I am sure that as we take a look at that over the course of the autumn of this year, that will continue to be at the heart of our strategy, and we will spend in the investment capacity whatever is appropriate to spend in order to keep business as strong tomorrow as it is today.

On HBOS Reading. If you look at the remediation charge for H1, the remediation charge for H1 was £425 million. That is composed of three components. One is the general insurance fine levied by the FCA that we disclosed about a week or so ago. One is HBOS Reading of about £150 million, and that is, as we disclosed, partly related to future operating costs and indeed today's operating costs, as well as redress. And the third component is £185m of other, essentially legacy-related redress issues. Again, of which a proportion is forward-look, operating, non-redress expenditure. So as you look at that going forward, one way to look at it is that the GI FCA fine clearly drops out. On the HBOS Reading fine, the forward-looking operational costs clearly drop out, as by definition we won't be taking them twice. But on the other hand, the redress costs may come in to compensate for that drop out. We will see about that; as we say, there is some uncertainty about the timing and the extent, but that is one way to think about it.

And then the third component, as I said, part of that is look forward, so an element of that drops away. And then part of that stays as an ongoing legacy item that we have to deal with. And so hopefully that gives you some picture as to how we see that unfolding over the course of future periods. What I would add to that is that none of the items that we are currently dealing with on the three points that I just made - the FCA general insurance fine, HBOS Reading clearly and the vast bulk of the legacy items - none of those are new items. They are essentially all legacy items, that obviously we are working exceptionally hard to address in the right and proper way. But they are items therefore, that we look to get beyond, and once we have done so, to put them behind us and then focus on doing the right thing going forward.

Jason Napier
Thank you and so just to follow-up on the materiality versus capital distribution plans, I don't know whether there is any way that there is some materiality as to overall distributions?

William Chalmers
I think the best way to look at it is to take what I have told you about future periods and how that charge might develop which hopefully gives you a sense of proportion, to recognise the capital position is a very strong capital position, and take into account some of the other comments I have made, about both the dividend and the excess capital considerations at the end of the year. But this remediation charge just plays its way through the P&L. As we see the capital position today, it is very, very strong despite that remediation charge playing its way through the P&L.

Jason Napier
Agreed, the beat on capital is bigger than the remediation charge, so thanks very much.

William Chalmers
As we think about capital distribution going forward Jason, to answer your question more directly. This is obviously a P&L factor that we have to take into account, but it does not alter our views overall of our capital distribution strategy.

Jason Napier
Thank you.

Question 10 – Guy Stebbings, Exane BNP
I just wanted to circle back on net interest margin again, firstly on the hedge, I wanted to check that the guidance of no headwind next year, can we take it that still implies a slight headwind versus the H2 2021 run rate? So I think the guidance for this year implies the second half contribution would be up slightly on the first half, whereas the comment for 2022 I think is in reference to full year 2021?

And then more broadly, as we think about headwinds versus tailwinds into 2022 versus the 2021 exit rate, I guess there are headwinds on the SVR attrition still, maybe a little bit of headwind on the hedge, unclear on new mortgage spreads versus the back book but then on the tailwinds, we have got funding benefit, perhaps unsecured starts to grow ahead of secured, from a mix point of view? In the round, it doesn't feel like we should be expecting a big move in NIM next year, perhaps slightly more risk to the downside than upside if new mortgage spreads drifted lower? Does that sound like a reasonable way to think about it?

William Chalmers
Thanks Guy, you are leading me into the territory of 2022 guidance. I will be a bit careful about what I say on that. But in essence on the hedge, it is pretty much a wash really. We have given the comments today that I gave in the script. But I think based upon current expectations for the yield curve in line with the market, it is not an awfully important factor in terms of the overall distinction between 2020 versus 2021 as a base, when you look forward for 2022.

As you look at the factors for 2022 on the margin, instead of giving you direct input on that, I will give you a sense as to what we see playing out in 2021, and you will then be able to figure out how that plays itself out into 2022. As you know, we improved the guidance on the margin today to around 250bps, on top of what we said at Q1. And it is driven by a couple of tailwinds and a couple of headwinds. The tailwinds first of all, are a bit of benefit from the yield curve that we have seen playing itself out through the structural hedge. That's number one. Number two, some capital cost savings - lower funding costs, lower capital costs coming together. Number three, some of the commercial bank margin developments we talked about earlier on. And those are all helpful tailwinds in the context of the margin. Now headwinds are essentially a larger mortgage book, which is tremendously attractive from a net interest income point of view and also an economic value added point of view. But it is, on average, at a lower margin, and therefore it is slightly dilutive from a margin point of view. And it plays itself out obviously the later on you go into the year.

There is also a little bit of margin dilution - a little bit, not much - of unsecured dilution, and that is simply because our credit standards in the current economic uncertainty are very high, and therefore you get a more dilutive effect from that unsecured book margin than you would necessarily normally get, in a more normal macro environment.

That picture I think because of the mortgage point that I made earlier on maybe shows a bit of a stronger margin development in Q3 versus Q4, simply because the weighting of that mortgages point is a little back ended.

But to come back to your question, all of this is activity dependent, and you have seen our economics over the course of this year, and the forecasts that we have for 2021 and 2022. If you see that economics as either different today or alternatively changing going forward, then you can see our asset growth, and in particular our asset growth in different areas is going to respond to that. And the most obvious point is the one that I was chatting about earlier on, which is that if we see stronger macroeconomic growth than we expect, then you will start to see, and you would expect to see, consumers use unsecured balances more than we are currently forecasting, for example. And that all plays itself into margin developments over the course of the second half of 2021 and the second half of 2022.

So I think take those two together, take our macroeconomic forecast, take our margin guidance and look at them as one, and think about how they might relate to each other.

Guy Stebbings
Okay, thank you.

William Chalmers
Just to say thank you to everybody for taking the time to dial in today, I appreciate the questions and will look forward to continuing dialogue. So thank you very much indeed.

END

FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements within the meaning of Section 21E of the US Securities Exchange Act of 1934, as amended, and section 27A of the US Securities Act of 1933, as amended, with respect to the business, strategy, plans and/or results of Lloyds Banking Group plc together with its subsidiaries (the Group) and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical or current facts, including statements about the Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. 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By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future. 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