LLOYDS BANKING GROUP PLC – Q3 2021 INTERIM MANAGEMENT STATEMENT – SELLSIDE ROUNDTABLE TRANSCRIPT
(amended in places to improve readability only)

Monday 1 November 2021 – 4.30pm

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William Chalmers
Welcome to everybody and thank you for joining the call today. I think we made most of the introductory comments last Thursday when we presented the results so it might make sense to go straight to Q&A today. So happy to address any topics that are important to people and with that, perhaps hand it over to those gathered on the call for Q&A.

Question 1 – Omar Keenan, Credit Suisse
Good afternoon, thank you very much for making the time. I have got two questions please, one on shareholder distribution and excess capital, and the second one on the strategic update. Firstly on the excess capital, I understand that this is a Board decision at the end of the year, but just to help get the framework right. The CET1 ratio was 16.1 per cent excluding IFRS9 and software intangibles, and on my numbers, the RWA inflation is around 15 per cent. So versus the hurdle, we are talking about £3 billion of excess capital with a possibility of management overlay releases to add to that. Can I ask, is the intention to only ever assess excess capital at the full year stage, and should we be thinking about a full distribution of whatever is assessed as excess, or might there be some retention for strategic optionality? And in a similar vein, on the growing size of the excess capital, versus what can be distributed, some banks have talked about liquidity being a bit of a constraint for in-market buybacks. So if I do some rough numbers for Lloyds buying 15 per cent every day, it is something below that excess capital figure. So I just wonder if specials are part of the possibilities?

And just a second question on the strategic update please. Could you talk about some of the priorities for management that we are likely to hear about? Thank you.

William Chalmers
Thank you for the questions Omar. On capital return, there are three components to your question. One is the amount, one is timing, and one is the form. So perhaps I will take that first of all. In terms of the amount, as you point out, the capital position at the Q3 end is strong at 17.2 per cent and you can deduct out IFRS9 and software intangibles on that to get to 16.1 per cent. Again, as you point out, we have noted some RWA headwinds at the beginning of next year which one needs to take into account when one looks at the excess capital position. But with all of that taken into account, the capital position continues to look pretty solid, pretty strong in fact. So, the nature of your question is not entirely surprising. I won't run the arithmetic on it, but I think the components that you outlined there are the types of components that we take into account when we are looking at the capital position. As for the timing, the capital decision of the Board, as you implied in your question, that will always be, and has always been, a year-end event, and I expect that to continue. So as I said before, and I think is consistent with the position that we are in today, the fact that we are not engaging in any excess capital repatriation right now doesn't mean anything. It is just part of our normal year-end practice, that we adhere to. I expect that certainly to be the case during the course of this year and I expect it to continue to be the case looking forward.

The considerations that we will take into account as we look at the capital position; we will obviously look at the stock of capital, we will also look at the outlook for regulatory change, we will also look at the conditions, the macroeconomic outlook, the state of the pandemic, that sort of thing, and the performance of the business at that time. All of those things will get taken into account. It is our aim to be consistent and reliable in dividends and any excess capital distribution over time. And so given the uncertainty, those are also likely to be a factor in timing. And so, when we look at the capital position at the year-end, we will take into account the stock, we will take into account the regulatory developments prospectively, we will take into account the macroeconomic uncertainties, and we will also take into account the ambition to, as I say, be a regular and reliable and predictable distributor of dividends and excess capital over time. But within that constraint, as always, we very much recognise the objective to return capital to shareholders.

In terms of the form, as you know the Group in the past has done special dividends, and the Group in the past has done buybacks. I think the form of the excess capital again is a question for the Board at the year-end. It is interesting in that context that the share price is below book, and in that context we obviously are focused on giving out an existing dividend yield in the form of sustainable and progressive dividend. But ultimately the form will be a matter for the Board, and it will have to consider investor preferences in that respect.

You mentioned strategic issues, Omar, what are the types of issues that the Board and indeed Charlie will consider from a strategic point of view. As you know I don't want to get drawn in too much to the strategic debate, that is what we are going through right now and we will be updating the market with our Q4 results in February, as to where we stand. So I would prefer to comment on the strategy at that point. Safe to say that I think the types of areas that we are considering probably wouldn't surprise you terribly much, that is to say, we are considering a combination of how best we can build upon the existing businesses that we have across Retail, across Commercial, across Insurance and Wealth. And how we can best solidify the areas where we have strength, consolidate those areas where we have strength, and grow into those areas where our market position is less strong, and you will be familiar with those including some of the activities that we have been doing this year.

It is also a question of modernising our offering to customers and I think also, a question within that, of making sure that our platforms are both addressing legacy issues as well as ensuring that our customer proposition looking forward is as adaptable and compatible with our ambitions as possible.

Hopefully that gives you some idea Omar. As I said, I don't want to get drawn too far into it because we will be talking about it in February.

Omar Keenan
Thank you very much, much appreciated.

Question 2 – Rohith Chandra-Rajan, Bank of America
Hi, afternoon William, I just have a few hopefully relatively quick ones please. The first few on mortgages. One of your competitors last week was talking about mortgage spreads reverting to around 100 basis points back to the 2018/ 2019 levels. I would just like to get your thoughts on that please?

And then I think on Thursday you quoted a back book spread of 133 basis points, I'm keen to clarify exactly what you were referring to. Is that the sort of churn spread, so what is currently maturing, rather than the overall back book? And we often talk about how SVR is rolling off or not, so if there is an update there as well please?

So those are the ones on the mortgages and then just a quick one on the hedge please. I was just wondering, given the action you have taken since the quarter end, if there is any change to the yield or average maturity or duration on the hedge please?

William Chalmers
Thanks for the question Rohith. In relation to mortgage spreads, mortgage pricing, as you know our completion margins in Q3 were around 160. The application margins at that time Rohith were around 140, and both of those were coming down versus what we saw in Q2, which were more like 175 on the completion margins. There is no doubt that application margins have continued to go down since the third quarter, we have been seeing a part of that. I won't give a precise number on it because I don't want to get into a kind of mark-to-market post-results on the precise pricing within our books, but I think it is safe to say that application margins have continued to trend down post the end of the third quarter below the 140 mark that we averaged during the third quarter.

The back book spread, yes it is exactly what you implied there Rohith. It refers to the churn of the current maturities. I think I referred to 133 basis points at a previous quarterly meeting that we had. During the course of the third quarter it was around 140 and so it ticked up a little bit, or the back book spread in relation to the churn to the third quarter was up a little bit versus the previous number of 133 at more like 140. But it is kind of there, or thereabouts, you can see the numbers in the same zone.

As for SVR, as you say, something that we keep an eye on too. The SVR book is around £68 billion now, so it is down a little, obviously, since the second quarter. And the attrition number, just to give you some sense of the speed at which it is coming down is at 14.1 per cent. So it is more or less in the same zone as it has been for some time now. That gives you a bit of an update on the turnover that we are seeing in the SVR book.

And then as to yield on the structural hedge, the fourth of your questions. The weighted average life on the structural hedge is a shade under three and a half years now, so it is about 3.3/3.4, in that territory. Not materially different to where it was at the half year where I think it was about 3.5 so it has come off just a tiny bit since then but basically in the same zone.

Rohith Chandra-Rajan
Thank you. Sorry is that an end-Q3 number and if so, has it changed much at all given what you have done in October on the hedge?

William Chalmers
It is an end-Q3 number, yes, just a shade below three and a half is an end-Q3 number and I don't believe it will have changed by much, Rohith, over the course of the last month.

Rohith Chandra-Rajan
Okay, thank you, and sorry, if I could just come back on the mortgage pricing. We started to see, with the lagging effect after swap rates moving out, a number of lenders moving rates up. In terms of your sense of where the market is going, do you see that as a continuing trend?

William Chalmers
Yes, possibly Rohith, but it is very early days to call it. I don't want to be too categoric on it. A lot of that pricing as you know has gone up post the swap moves that we have seen over the course of the last month. And so naturally, lenders have seen their margins get squeezed off the back of the swap moves and sought to respond accordingly. We have seen that across lenders across the market and as you know, we have taken action ourselves in that respect. I think where it has been most marked, Rohith, is in the low LTV part of the book, there's been less price increases in the higher LTV part of the book where there are slightly higher margins. So it is having that pattern in terms of how it is impacting different areas of the book differently. As I say, Rohith, the short answer to your question is yes, it does appear to be part of a trend in the market. But the longer answer to your question is that it is very early days to make that call, so I wouldn't want to be too categoric on it yet.

Rohith Chandra-Rajan
Okay that's great, thank you very much.

Question 3 – Guy Stebbings, Exane BNP
Hi good afternoon, thanks for taking my questions. The first one is on operating lease depreciation and then one on the hedge. So I guess operating lease depreciation has moved around a lot given the lower activity, and the movements to residual value, and whether it settles around the current run rate of less than half a billion, or back to one billion, makes a pretty big difference. I just wonder under a scenario where activity rebounds, you would expect, assuming negligible movements in residual values, what should we be thinking about? Is a £700-750 million type figure reasonable and over what sort of time frame might we get back to the previous high levels?

And then on the hedge, thanks for the comment you have given so far, and the confirmation in terms of tailwind into 2022 now. Can I ask about 2023, as I think you had said in the past that what would be rolling off then would be from higher rates given the duration, and when it was put on. So I wonder if you could clarify if you expect it be a headwind in 2023 versus the current run rate? If you are, that would seem to imply the average roll off must be pretty high given where the notional balance has gone to and where the prevailing swap rates are. But any comment there would be very useful, thanks.

William Chalmers
Thanks for the questions Guy. On operating lease depreciation, as you say we have seen a pretty subdued picture, i.e. low charge, during the course of this year in fact, not just in Q3. That has been a function of both structural and cyclical factors. The cyclical ones obviously being the used car price developments which have been strongly supported by supply-side constraints and so forth, and that has helped as we look at things like loss on sales, depreciation charges and so forth. That has reduced the operating lease depreciation charge. It has also been partly affected by the Lex fleet size as well, which is more of a structural factor and has been going down by 6 per cent over the course of the year. That continues to be a bit of a pattern as corporates make their choices. What that all means for the remainder of this year is a continued pretty modest operating lease depreciation charge as we go into Q4. I wouldn't expect that to be massively different from Q3 on the basis of what we have seen so far, but we would expect at least the cyclical support for that to start to come off in the course of 2022. We do expect used car prices to come back a bit from where they are today, which in turn will then drive depreciation charges and loss on sale charges essentially, which in turn will then drive the operating lease depreciation charge up a little bit. But I think that is likely to be quite gradual, and so as we look at the market, we don't anticipate prices falling off a cliff, frankly. And therefore we do anticipate the operating lease depreciation charge to come back, but in a relatively gradual fashion, and not immediately reverting to 2020/2019 type levels.

On the second of your two questions, on the hedge. I think overall we are looking at the hedge, I think I said on Thursday, that we saw the hedge for 2022 as being essentially a tailwind to the performance over 2021. I think overall in 2023 we are looking at it being more neutral, essentially more or less flat for 2022 is our expectation. Clearly, that is subject to interest rate developments and where they go, as they will affect the maturities in that year, which I think I mentioned again on Thursday will be somewhat higher in 2023 than they will be in 2022. But with that caveat, I think roughly flat to 2022 would be our expectation for 2023.

Guy Stebbings
Okay thanks that is really helpful. I don't know whether I could push you on the operating lease depreciation charge. If the consensus number, which I think is coming out in the ballpark range I mentioned before, just 750, if that feels like a reasonable assumption for the next 12-18 months or so as a run rate?

William Chambers
I wouldn't want to be drawn too precisely on any of the guidance Guy, but I think that fits the description, roughly speaking, that I gave earlier on.

Guy Stebbings
Brilliant, thank you.

Question 4 – James Invine, Societe Generale
Hi, I have got one on capital please, specifically about the stress test. One notable feature of the stress test is that you are always quite a big outlier on your stress impairment charge for the mortgage book, and I think previously you said that was from the '06-08 vintages. I was just wondering if you could tell us how the proportion of that within the book has changed over the past couple of years and if we should be expecting a performance much closer to your peers this year, on that specific point of mortgage impairments?

William Chalmers
Thanks for the question James. I think the overall stress performance in the past has certainly been impacted by the heritage book, as we call it. Overall, from a methodology point of view, I wouldn't necessarily expect that to change, albeit the stress, as you know, is a slightly different form of stress this time, whereby we see a sharp contraction followed by then an equally sharp recovery. So that does have an effect in terms of how the stress numbers come out. Meaning James, that typically off the back of that type of environment, you will see a sharp uptick in RWAs as expected losses come in, but then the actual provisions which usually come in, in years thereafter, are perhaps less severe than they would be if you saw a sustained downturn for a number of years. So this is a different stress and it does produce different results. Having said that, the legacy book from that 06 to 08 period is likely still to be a factor, despite what I said. To answer your question and give you some idea as to how it has played out, it is now around £46 billion, the legacy book, that is around 15 per cent of the balances as your maths will tell you. It has done in the past, and I expect it will continue to, represent a significant part of ACS losses in any stress that is done. Having said that, it has not been overly represented in payments holidays that we have seen over the course of the Coronavirus pandemic, which I think is quite an interesting statistic or observation in its own right.

I think also, to give you some further idea, the average LTV for that legacy book is about 39 per cent. The average loan is now only a shade over £100,000 and as you know, from the date of inception, those are all now pretty well seasoned balances with more than ten years of HPI growth. So James, it will feature in ACS losses, but on the other hand the performance of the book in reality has been pretty strong over the course of the Coronavirus pandemic, and indeed if we do a reality check on it we think it is in pretty decent shape.

Further question
It seems remarkable that 15 per cent of your book, that has got an LTV below the other 85 per cent, can kind of bring you out with a stressed impairment charge of 3 per cent versus 1 per cent for the other banks. So does it just have a disproportionally high probability of default assumption on it or something?

William Chalmers
I think yes, it is partly that. It is partly the nature of the mortgages within it, partly the nature of the customer base. Those are all factors which have led to that ACS outcome.

James Invine
Okay, all right, thank you.

Question 5 – Robin Down, HSBC
Good afternoon William. I have got one numbers question, and a couple of slightly broader questions. The numbers question, just on the equity gains that you took, were they all from LDC, or did you also include a BGS gain within that?

And then two slightly broader questions. One was around the dreaded interest rate sensitivity. We all kind of focus on the deposit betas, but can you give us some sort of colour about what you might have assumed on the mortgage side? I think we are all kind of talking about how the new business spreads have shrunk and swap rates has risen. But I assume that within your sensitivity, you probably do have some allowance for perhaps rising rates not being passed on in full to new mortgage customers etc, or am I completely wrong on that?

And then just the final question, you mentioned earlier regulatory developments. Obviously Basel 3 looks like it has been delayed in Europe to at least 2025, and I guess it sounds like the PRA is probably going to follow suit and go the same way. Do you get to a certain point where Basel 3 is sufficiently far off that you just don't take it into account really when it comes to thinking about the level of capital? I mean if we are talking about 3 to 4 years away before it comes in, does that affect your decision in February 2022 in terms of the amount of capital you can hand back? Just any thoughts you have got on that would be great, thank you.

William Chalmers
Thanks Rob. Three questions there, equity gains, deposit and mortgage betas and regulatory developments. In the third quarter the equity gains were very largely LDC. So with respect to the performance of LDC in the third quarter, it has kind of a quarterly run rate. We think that it over-achieved on that by about £100 million off the back of two exits that were both surprises in terms of timing and surprises in terms of quantum, i.e. much better than I think we had marked it on our books. So in the third quarter very substantially LDC but then if you track back before that, then you will see BGF come into play a little bit in the first quarter and a little bit in the second quarter. We saw BGF strong performance in the first quarter, we weren't sure whether it would be sustained or not and so we took it in the first and the second quarter. And [so] you will see some element there from BGF. But not so much in the third quarter.

Robin Down
The only reason I asked that is that we also saw gains for your peer group earlier on in the year and they have all taken a further gain in Q3. Should we be expecting something then in, perhaps Q4, from you, or do you think you are kind of up to date on that?

William Chalmers
I think on BGF we are pretty up to date, Rob. We took some in the first quarter, we didn't take it all - we waited to see what would happen in the second quarter, then took some in the second quarter again and LDC took over in the third quarter. In terms of lumpy items in the fourth quarter, I think the only thing to look out for that we are aware of as we stand, is the annual basis review within insurance, which is a fourth quarter event every year. So that is one. We don't have an opinion on what that is yet because the work is still to be done, but that is the only lumpy item that I would look out for at the moment.

Second of your questions Rob, on deposit betas and mortgage betas. The deposit beta of 50 per cent is, as you know, put there as an illustrative number. We wanted to avoid being too specific, because there is no doubt that in reality actual behaviour will always differ from any given assumption that you make. But we wanted to put down an illustrative assumption of 50 per cent just as a place marker for what this might be. As said on Thursday, I think roughly speaking anything less than that, that we pass on, is roughly linear in terms of the numbers.

On the mortgage side, again we followed convention there. Perhaps on the deposit beta side it is fair to say that different institutions take a different view as to what they would like their pass-on assumption for deposits to be. On the mortgage side, I think convention is very much just to assume that the whole amount is passed on. And so for us, and I think for everybody else, but obviously I can only quote for us, there is a 100 per cent pass on assumption within mortgages, which of course you have to see in reality whether or not that is the case, and the competitive conditions will dictate that; mortgage supply and mortgage demand. But that is the simplifying assumption that we have made, and I believe that is consistent with the convention across the sector.

On the third of your questions Rob, regulatory developments, it is a good question. We saw two movements - the European movement late last week, and then the PRA statement today. The European movement was a bit more definitive in terms of where Basel 3, or rather when Basel 3.1, was going to land. It also had in it one or two interesting changes to the base case for Basel 3 involving SMEs and also CVA, both of which were pretty positive versus our base case for Basel 3.1. The PRA was much less definitive on timing and also, what impact this might have. A couple of comments. First, if the PRA chose to follow any of those European developments with respect to SMEs or with respect to CVAs, both of these would be positive developments versus our base case on Basel 3.1 and therefore would be a net RWA benefit reduction from our base case estimates. We will have to see obviously - the PRA has not given us any indication either way, so I am really just going by the European comments there.

In terms of timing, while the Europeans said 2025, the PRA said 'we will get back to you' on the timing. I think as to your question Rob, at what point do we lose interest in them, I think anything that comes in within the next two to three years, maybe a little bit longer than that, we are going to pay close attention to. So if they were to come up with a delay, to let's say 2025, that is certainly relevant in terms of our capital planning, in terms of our pricing, in terms of our overall approach to the market. Interestingly when they talk about output floors going into the 2030s, i.e. being implemented in 2030 and beyond, at that point you are starting to lose the point of contact with the lending that you are writing against any given price or RWA. I think once it starts to extend into a time frame that goes beyond the duration of any given lending, is when you start to struggle to think about how to deal with it. Other than from a systems and operational point of view, we obviously seek to build in flexibility as soon as we know that the event might happen.

Robin Down
Great, excellent that's brilliant, thank you.

Question 6 – Chris Cant, Autonomous
Good afternoon, thanks for taking my question. If I could just come back on operating lease depreciation please, just trying to understand the dynamics there a bit more. So should we be expecting the Lex fleet to continue to contract into 2022 or is that something you will be looking to regrow, obviously there is a consequence there for other income as well - if that continues to shrink, it will be putting pressure on your Retail other income? How are you thinking about that? And what have the year to date gains on sale of leased assets have been, please, just so we can think about the underlying run rate? That would be a really helpful figure to have.

And then on costs, just thinking about the language you were using around costs on the call last week, speaking more about cost discipline alongside investments. Should we be expecting costs to be flat to slightly up next year rather than down? Thank you.

William Chalmers
Thanks Chris. In terms of the overall view on operating lease depreciation Chris, I think in terms of the development for the remainder of 2021, going into 2022, I hope we have given you a reasonable picture. I think the question on Lex, as I said, it has come down I think around 6 per cent, maybe a shade over 6 per cent, over the course of this year. I think what is behind that is corporates, making choices as to lease volumes. Overall, that appears to be a trend that has been in evidence for a couple of years or so now. I don't see that as necessarily being a trend that is going to turn around overnight. Having said that, there is a change in forms of transport going on, and we are now a significant electric vehicle leaser. We have to see whether or not that type of change, in the substance of what is being leased, actually makes any difference to corporate leasing behaviours. But I think overall, Chris, that development in Lex that has been going on for a little while. I would expect it to most probably continue, albeit potentially at a slowing rate, because those corporates that have made their choices or rather are going to make their choices, probably have already made it. To the extent that it does continue, you are right, it works its way through not just operating lease depreciation, but also other income. It is certainly an element in that as well, and a flip side to the same coin really.

On the gains on sale of leased assets, I will not give you that number because I don't think we have disclosed it before. I am happy to be corrected on that point by Douglas, and if so he can give it to you outside of this call, but I don't think it is a number we have typically disclosed before Chris.

Chris Cant
You used to give it half yearly but it wasn't in the Interims this time, which is why I was asking. I think it used to be part of your disclosures.

William Chalmers
Okay, well let me get back to you on that Chris, and we can see. If it was given during my tenure, then I will certainly take a look at it and discuss it with Douglas.

In relation to costs, obviously an important area. I don't have much more to say than what I have said on Thursday, which is at the moment we don't want to give guidance on costs in 2022, and the reason for that Chris is because we are obviously looking at the planning numbers now, not just BAU but also the strategic plan. We will be coming out with guidance on that in February and that feels like the right time because as I said we are in the throes of discussions and decision making now.

Having said that, just to comment further, or to repeat what I said on Thursday, cost management is a source of competitive advantage for us. We do have in place what has been a very effective framework. At the same time, as said on Thursday, we obviously, just like everybody else experience general inflationary pressure, as to people, as to opex. Also and importantly, we do run costs in relation to income-generating initiatives that we embark on, including the Embark acquisition and also including things like Citra. So you will see costs from that, but again I think, within that, we have been good at managing costs, we will continue to be good at managing costs. It will continue to be a focus for the Group. As we look at that line item on the P&L, perhaps worth bearing all of those points in mind, Chris.

Chris Cant
Okay, all right thank you.

Question 7 – Gary Greenwood, Shore Capital
Hi, I have got a couple of questions if I can please. So the first was coming back on mortgage pricing. So I think you talked about the sort of 140 basis points on application spreads in Q3. And I think NatWest quoted a figure of 115 basis points, ending the period at 105. I was just wondering why you thought there was such a difference between what you are seeing and what they are seeing, whether it is a difference in business mix, or it is just not comparing apples with apples there?

And then I guess related to that in terms of pricing coming down. At what level do you think we need to get to, before writing mortgage business becomes uneconomic, do you think we are really close to that level now in terms of pricing?

And then second question was on risk weighted assets, just the risk weighted asset walk really, between your guidance for the end of this year of just under £200 billion and then for the end of next year of £210 billion. I think you have talked about £15-20 billion inflationary or regulatory issues coming in at the start of 2022. So I am just wondering given that I would imagine you would expect some growth in the book and maybe a pick up particularly in riskier areas so credit cards etc., sort of what the difference is? Because it looks like there would be some underlying reduction in risk weighted assets to get from the 200 to the 210?

William Chalmers
Thanks for the questions Gary. In terms of pricing, I won't comment too much on other people's pricing initiatives, but I think you can probably see in terms of our overall pricing in the market that we have typically held up our pricing in a slightly different fashion to some of our competitors and perhaps including the one that you mentioned there. Again, I can't comment on what the foundations are for their particular completion or application margins during the quarter, or what they are seeing, but I do think if you look at the publicly available data, you will see our pricing trends differ to theirs. And that obviously leads to different outcomes in terms of completion margins and application margins. Partly because of timing, partly because of the areas of the market that we typically target. So I do think there are differences there, Gary, in terms of the way in which we have implemented pricing strategies. As said, that then feeds its way through into the completion and application margins as part of the book. The only further point I would make on that is that, at the same time, we are seeing, broadly speaking, the same trends. They just perhaps, at the margin, impact us a little bit differently for reasons that I just mentioned.

Now in terms of uneconomic or otherwise pricing on the mortgage book, I won't give you a number for that for obvious commercial sensitivity reasons. At the moment, we see the business that we are writing, we took 18 per cent share in Q3, application margins at 140, we continue to write into the current environment and we do see it as economically, EVA and returns-basis, attractive. For now at least we see it as economic, I won't give you a threshold level at which that changes.

And then for your RWA question, it is obviously an important development for us and we gave the half year disclosure there for year-end 2022 which I think is where your question is coming from Gary, as to around £210 billion RWAs for year-end 2022. Now clearly when you give a number that far out, particularly when it is dependent upon the facts that I am about to go through, uncertainties remain. But with that, the types of factors that are driving that RWA outcome are regulatory headwinds, macroeconomic factors, including obviously levels of activity, and our optimisation activities, typically what we will do in relation to the commercial book.

So if I talk through those in a bit more detail, we will finish up this year below £200 billion. As said we don't expect that number to be 199.9 or 8 for that matter, we expect it to be a notch lower below £200 billion at the end of this year. We then step into 1st January 2022 and then we expect to see regulatory headwinds. I think we put a number of £15-20 billion on that in the course of 1st January 2022. It is composed basically of two main areas. CRD-IV models which primarily relate to mortgage models, definition of default, that type of thing. But also things like hybrid probabilities of default and loss given defaults peak to trough, which in turn mainly goes to the mortgage model. It is also composed of CCR and CVA, which then adds about another £3-5 billion or so of RWAs. That is one component. We then would expect that over the course of 2022 to be lifted up a little bit by activity, but at the same time we are then seeing pressures that go the other way. For example, you will see the software amortisation come off. That will give us about £1.5 billion of RWA benefits. You will see optimisation within the commercial business continue. That will give us reasonably significant benefits over the course of the year. The net of all of that, obviously activity- and macro-dependent, gets us down to our around £210 billion number. So hopefully that gives you a sense as to building blocks for what we expect to see next year.

Gary Greenwood
Yeah that is really helpful, thank you very much.

Question 8 – Andrew Coombs, Citi
Good afternoon. Two questions following up on some of the previous discussion points. If we look at your old guidance, you used to talk about capital generation of 170 to 200 basis points per year. We look like we are moving back to a similar rate environment. But I remember you used to pay out 40 per cent of earnings I think. At peak it got to about 60 per cent. Is there any reason why that payout ratio should be in that threshold or, given that we have addressed PPI, regulatory headwinds are now easing or being pushed out into the future, is there any reason why the payout ratio couldn't be higher than that of the underlying capital generation? That will be the first question.

Second question is going back to the interest rate sensitivity, there has been a lot of debate around deposit betas, there has been a lot of debate around how the banks are projecting going forward. But one of the things that does stand out is that when you look at your interest rate sensitivity on year one which is mainly the managed margin, your sensitively look somewhat lower than some of the peers. I am just trying to get a feel for why you think that might be. I know you are no expert on how the others are modelling this so I have some sympathy. But you are talking about 100 per cent pass-through on tracker and SVR, your SVR book is much bigger than peers. If I look at your liability mix, the gap, in terms of current versus savings, appears to have narrowed. So why do you think your interest rates would be lower in this hypothetical sensitivity analysis? Thanks.

William Chalmers
Thanks Andrew. In terms of the capital generation, the first of your two questions, there are a couple of points in that. One is to quantum, the second is to payout ratio. I will comment on both of those two. You have seen capital generation over the course of this year being pretty strong. I think capital generation so far this year has been about 159 basis points, which is clearly a strong performance. It has been driven by a number of things, including the underlying banking earnings, which in turn have been supplemented by a benign credit environment, albeit that is largely offset by transitional reductions. At the same time, we have seen pretty benign RWA trends which have been helpful over the course of the year too. That has driven a pretty strong capital generation for the 2021 period. Now, as we look into 2022, as per the question we were just talking about with Gary, there are some regulatory RWA headwinds coming over the course of 2022. So in 2022, you need to look at both the underlying performance, which will be a question of recovering profitability, normalising impairments, we just talked a bit about the headwinds. That underlying performance offset by those regulatory headwinds, as said, over the course of 2022. So it is a slightly different capital generation picture for 2022.

Then going to your question Andrew, in the years thereafter, clearly the regulatory headwinds at that point start to disappear as per some of the previous questions that we discussed, but for 2022 at least, that is a factor.

The next part of your question Andrew, what does all that mean for our payout ratio? Our dividend policy is set around progressive and sustainable, so as a result we don't really think about it in terms of the payout ratio. We do think about it in terms of the desire to ensure that we have both a progressive and a sustainable dividend payout going forward. Although those words sound somewhat a bit like what everybody else says, they are important words to us. So as we think about the overall ability to pay the dividend going forward, we want to make sure that it is both progressive and sustainable, and we have calibrated the dividend policy based upon that, to ensure that we can deliver. Hence, apart from in truly exceptional years, I don't think you will typically see us run the dividend policy as a function of payout ratio so much as a function of our progressive and sustainable commitment.

Second question, interest rate sensitivity. As you say, it is a little difficult for me to comment on other people's sensitivity. All I can really say is what is in ours. A couple of points to make within that. As you know, the sources of our interest rate sensitivity are essentially: the structural hedge; margin widening through pass on assumptions; and then thirdly, the leads and lags in the book. We have got £225m year one interest rate sensitivity. It won't surprise you that the hedge component of that 225 is relatively modest in year one, it starts to accumulate in the years thereafter. Then we have the residual being split between margin widening through the pass on assumptions that we have made, and also the overnight hedges rollover, so that is very short term balances that roll over in terms of the hedges. That together, is what is giving us the year one sensitivity. I can't comment on whether it is more or less than others.

I think I will make perhaps just two points though, Andrew, to finish up. One is, take a close look at the assumptions that different people are using, as that often is what drives different interest rate sensitivities. Not everybody is using the same deposit pass on assumptions for example. Some are being a bit more aggressive than we are. That is one point.

The second point is that also, having said that, we have a deposit balance against which one can apply interest rate sensitivity - the variable rate savings effectively. Some part of that overall deposit balance - current accounts, equity - are already in the hedge. So when you look at how much the base rate pass on should be applied to our variable rate savings book, you have to take out that part of the overall deposit balances that are already included in the hedge and already hedged against. That is what is in our hedge capacity of 215 today. We don't want to double count that Andrew and that is conceivably a second part of the answer, as to the difference in interest rate sensitivity.

Andrew Coombs
That is very helpful, especially the last point. Just coming back to the payout ratio. I mean your commentary was with respect to the dividend, I guess when I am thinking about payout, I am thinking of dividend and buyback combined. If I think about the excess capital you are holding today, that is more than enough to sufficiently absorb the regulatory headwinds you are talking about for 2022. So I guess my broader question is, if you think about dividends and buybacks combined, is there any reason why you couldn't be distributing 100 per cent of earnings in the coming years?

William Chalmers
I think we have probably given you all of the factors that would be relevant to that consideration, is the best way to address that question. We will look at the end of every year, the capital stock, the macro uncertainties, the regulatory headwinds - those for example on the 1st January, also including things like counter-cyclical buffer and those type of things. Also, the outlook for business performance and how that hopefully improves in a post-pandemic environment as the macro improves. We will look at all of those factors and weigh them up in the round, and then take a decision based upon an understood importance of distribution, as far as shareholders. We will take a decision in the round in that respect.

With the final overlay, Andrew, again we would aim to be consistent and reliable and predictable in terms of our capital distributions for dividends and for excess capital over time.

Andrew Coombs
Very helpful, thank you.

Question 9 – Jonathan Pierce, Numis
Hello there, thanks for doing this. The first point actually is, if I can just to back up what Chris was asking on the profits on the operating lease assets, because I think you definitely did disclose that in the full year accounts of 2020 and I think those profits were averaging about £75 million a year in the three years to end of 2020. It feels like they are probably somewhere between £200-300 million now. So that disclosure would be really helpful to have. The next question is a slightly out-of-the-box suggestion maybe, but you are clearly awash with surplus capital now, however you look at it. I just wonder whether it may be time to deal with some of the legacy aspects that are still dragging on at P&L. I am thinking in particular about the HBOS subordinated debt from the financial crisis. You have still got a significant fair value unwind which is dragging by 40 to 50 basis points on the return on equity every year. You could find that is going to be there for quite a long time. Are there other things like that, that you can maybe do with the surplus capital that the market maybe isn't thinking enough about, or is the net present value just not positive in this case so that isn't something you do? Just interested in where else you can maybe use some of the surplus capital that we may not have thought about properly.

William Chalmers
Thanks for the questions Jonathan. On the first of those two, operating lease depreciation profits, as I say, I will take a look at it and if it has been disclosed before, I am happy to disclose it again. I just want to take a look at it before doing so. So we will get back to you on that.

On the surplus capital point, as you say, the capital position is pretty strong. It is important to us that we are able to give the returns in an orderly and consistent way over time. It is also important to us to take account of whatever it is the macro might throw at us. The progress of the business that we want to see including investments in that context. But nonetheless, the capital position looks pretty strong and we will obviously have a healthy discussion at year-end. In terms of unforeseen usage, to your point Jonathan, I am not sure there really are any that I would particularly highlight in that respect. We try to make sure that the balance sheet is as transparent as possible. You know what is in there, from our disclosures, by way of intangibles. There is nothing in there that is particularly surprising, that isn't part of the regular year-end review process and hasn't been for some time. We think without commenting too specifically on it, the business value behind each of those intangible decisions remains pretty solid, pretty sound. I don't think I would really highlight anything that won't have occurred to you Jonathan in terms of uses of that capital. Perhaps that is all I can say on it actually. I think it is intended to be a transparent balance sheet, which is well understood and hopefully that doesn't give rise to too many surprises. The decisions over the course of the coming years, of course might change the way in which we do things like technology developments conceivably, but those are decisions for a later day.

Jonathan Pierce
Okay wonderful, thanks a lot for that.

Question 10 – Fahad Changazi, Mediobanca
Good evening. Some questions on insurance, not IFRS17-related. You mentioned on the Q3 call that you wanted a growing dividend from Scottish Widows. Could you marry that up with your growth ambitions in annuities and also your ambitions for increasing market share in protection, which provides a partial offset?

Also it looks like a listed annuity insurer, Rothesay, is looking to offer 25 year fixed mortgages. No idea what kind of demand will be for this product, but would that be an attractive asset class for Scottish Widows? What are your thoughts there?

And also a final thing if you don't mind, your annuity book might be some way off from being self-financing, but what is the size of the annuity book currently? Thank you.

William Chalmers
Thanks Fahad. In terms of the insurance dividend, it won't surprise you that we have always managed the insurance dividend very carefully. In the past, before my time, the insurance dividend was subject to some significant one-off benefits, largely from capital management techniques, which supplemented the BAU dividend that comes out of the insurance company. I think you saw in the 2015-2016 time period, some quite meaningful one-off dividend benefits from capital management activity, that was then to an extent at least supplemented by one or two other benefits in the 2017-18 period. Those have largely been done Fahad, so now we move into a more sustainable or more consistent pattern of insurance dividends both today and going forward. And that pattern of managing the cashflow of insurance and making sure there is an appropriate dividend up, subject to the needs of the insurance business, has been an ongoing strategy. IFRS17 has clearly come along in the interim period, but it hasn't actually changed that fundamental approach to managing the business and to paying close attention to things like solvency II equity own funds metrics, both as to a capital quantum and also in terms of the Solvency II cashflows that come off the business that we write. So the attention paid to that underlying dividend was there yesterday, it is certainly there today and it will be there tomorrow.

In terms of the mix of the business that we see, you will be aware I think, that the growth areas of the business have been protection, workplace, and GI. All of which in various ways offer attractive returns on capital. There have been one of two changes in terms of some of the areas there. GI for example has been subject to the FCA pricing study. In the near term at least, that introduces a level of volatility. Over time, we think that will play to the strength of scale players, and we do believe that we are a scale player, and allow us to continue to earn attractive returns on capital in that area. Likewise, protection and workplace are slightly different dynamics, but fundamentally we see ourselves as long-term scale players in those markets.

The one area that is capital intensive, that we continue to be judicious in terms of our approach, is bulks in the annuity area. That is typically a capital intensive area. It is also an area that has been subject to some considerable pricing competition over the course of the last couple of years, and so we have been very careful about participation in the bulk market. We have only done it where we have seen it to be attractive from a value perspective. You have seen that, I think, come through in our quarterly earnings. We have always been pretty clear when we have a quarter with bulks and when we have a quarter without bulks, the difference that it makes. In terms of the overall size, the size of the individual and bulks asset is around £18 billion, of which around £6 billion is in bulks I believe. So that gives you some idea of the scale.

Then just finally in terms of the Rothesay strategy on 25 year mortgages, again obviously without commenting on Rothesay, we have seen limited customer demand for mortgages at that level. We have looked at it before. I think the point of comparison is often with the US market in this context, but the absence of Fannie Mae and Freddie Mac makes this a fundamentally different market. It makes 25 year mortgages that much harder to write, and it means the customer proposition is that much less attractive from a customer perspective. The one mortgage area that is somewhat similar that we do participate in, albeit on a very modest scale, is equity release mortgages. But again at the moment that is at a very modest scale.

Fahad Changazi
Right, thank you very much.

Question 11 – Ed Firth, KBW
Afternoon everybody, thanks very much. I just have two questions. The first one was the pension deficit. I guess that is a big use of capital coming forward. Could you just update us on where we are today, or the most recent valuation in terms of how that is? And also I don't know if you have had discussions with the Pensions Regulator, I thought he was making some comments about companies returning capital to shareholders, at the same time as having big pension deficits? I just wondered whether you had any discussions on that? So that would be question number one.

And then the other question was looking at your amortisation of software intangibles and your spend, you have got about a £300-350 million gap there. Over what sort of time should we expect those to converge together because I guess one has got to meet the other at some point. Is that a fair assumption?

William Chalmers
Yes, thanks Ed. On the first of the two questions, on the pension deficit, as you know, that is measured through two metrics, Ed, so it is accounting surplus and the actuarial surplus. Both of them are measurements of the pensions position. The accounting surplus for this quarter, for the third quarter, is £3.1 billion versus I think it was £2.9 billion at H1. That has increased a little bit by virtue of two things. One is credit spreads, and the other is contributions. So credit spreads have widened slightly, that helps us in terms of the accounting surplus. Contributions have obviously taken place as per usual. So that has in turn helped the surplus a little bit. The actuarial position is assessed once every three years, and was last assessed as of year-end 2019. And that is currently the year-end number plus the £1.7 billion added by the RPI/CPI issue that's being contested in the courts, total of £7.3 billion.

Ed Firth
You have paid some contribution since then haven't you?

William Chalmers
Yes exactly, that is where I was about to go Ed. If you look at the contributions since that £7.3 billion, we have now had two years, so we have made contributions of £1.6 billion or thereabouts. There is also this question about the £1.7 billion and what is going to happen to that, in terms of the court case that is going on now. We are not involved in that court case; other large corporates are. I don't want to speculate too much on where it goes really Ed, but we just have to see. It is a component of that £7.3 billion, I think is the point. As I said, you can take out contributions of £1.6 billion, you can take a point of view although I would encourage you to be cautious on that £1.7 billion RPI/CPI debate. I would assume that it is part of the deficit until you hear otherwise, would be my suggestion.

There is a further point which you can speculate on, but again I would be very cautious with it, about what is happening to rates right now and the extent to which that makes any difference to the next pension valuation in a couple of years' time.

Ed Firth
I just wondered William, a lot of the other banks give us some sort of an update, like a desktop. It is a pretty material number in the context of your market cap that we just don't know, that we sort of fly invisible for three years. Is it not possible to give us some sort of update, just like a desktop exercise, of this is roughly where we are today?

William Chalmers
We could look at that Ed, we haven't really done it so far, but we could look at it as an element. I think overall, on your question about whether the pension, in this case obviously the actuarial pension, acts as a blocker towards capital returns, I hope we dealt with that at the year-end, in the context of the renegotiation with the trustees, where we have a fixed contribution of £800 million and then we will make 30 per cent of any additional contributions to shareholders. So if we payout a dividend of a billion, we make a further 30 per cent contribution to the pension fund in that context, subject to an overall cap. That means that the pension deficit does not act as a blocker to capital distributions, with that incremental caveat that I just mentioned.

Importantly Ed I think your question referred to the Pensions Act and whether or not that was going to be a concern. The structure that we have agreed with the trustees I think takes care of that concern. That is to say, the Pensions Act has come in and it has said, for those companies that have large pension deficits we don't want them distributing huge amounts without paying attention to their pension deficit position. We are in a position where effectively our discussion with the trustees has addressed that issue. The further capital contribution or capital repatriation that we make to shareholders will be accompanied by a 30 per cent contribution to closing the pension fund deficit. So that has effectively dealt with any concerns that might arise from the Pensions Act.

Ed Firth
Perfect okay that's great, thanks very much. And then the other question on amortisation?

William Chalmers
The software spend has been very consistent in terms of the capex rate for the software spend, so around the sort of 65-66 per cent type rate for the intangibles capex rate, or the capitalisation rate I guess, that has been applied. Over time, the amount of money that is spent, or has been spent, on intangibles, has gone up and down. Over time it will start to get factored into the overall numbers and result in the equilibrium that you are suggesting there Ed, but I don't think it makes a dramatic difference in terms of our overall cost planning in the coming years.

Ed Firth
Right. I mean just over £300 million makes it quite a chunky number, it is like 4 per cent of your cost base?

William
Yes, it is. Over the course of the next year or so, it is a number that isn't moving terribly much as a component of our cost base.

Operator
There are no further questions on the phone lines at this time.

William Chalmers
All right, why don't we close it with that. Just to say thanks very much indeed to everybody for joining. I hope that it was a helpful session and look forward to continuing the dialogue. Thanks very much indeed guys.

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