LLOYDS BANKING GROUP PLC – 2021 FULL YEAR RESULTS AND STRATEGIC UPDATE – SELLSIDE ROUNDTABLE TRANSCRIPT
(amended in places to improve readability only)

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LBG:
Charlie Nunn, Group Chief Executive
William Chalmers, Chief Financial Officer
Carla Antunes da Silva, Group Strategy, Corporate Development & Investor Relations Director
Jon Burgess, Group Financial Controller
Cecile Hillary, Group Treasurer
Douglas Radcliffe, Group Investor Relations Director

William Chalmers
Welcome to everybody and thank you very much indeed for joining this afternoon. You have on the line in addition to myself Douglas Radcliffe, Jon Burgess and Cecile Hillary. Jon Financial Controller, Cecile Group Treasurer and Douglas of course you know.

I think given the presentations last Thursday we will just go straight to questions. So perhaps I can just open the line and invite any of our colleagues in the analyst community to ask questions as they wish.

Question 1 – Rohith Chandra-Rajan, Bank of America
Hi good afternoon, it is Rohith, from Bank of America. I have a few please. The first one is just a quick clarification hopefully. Just on the 75-100 basis points mortgage spread that you indicated. Can I check whether that is relative to swaps or does the funding cost include some liquidity premium? That would be the first one.

Then the second one on capital. So you are capitalising about £1.8 billion of expenses over the next three years so that is about 80 basis points of CET1, less any depreciation along the way. I just wanted to check whether that is included in the 150 basis points annual capital generation that you anticipate?

And then finally just on surplus capital distributions, will that continue to be a year-end decision please?

William Chalmers
Thank you Rohith. On the first of those three, 75-100 basis points, that is relative to swaps. So those spreads are just that described.

Second, capital generation, basically everything is included in that 150 basis points, except for the variable component of the pension contributions. So what I mean by that is, as you know, we have 30 per cent of in year shareholder payments to be made in the form of variable pension contributions. That is as a function of the dividend and this year as a function of the buyback. That component, 30 per cent of that is deducted from the 150 basis points capital generation. However the fixed contribution for pensions, which as you know is £800 million, is before the 150 basis points. That is in our expense base. So it is only the variable component that comes out. But in directly answering your question, any capital expenditure, depreciation, everything else, all of that is before you get to the 150. That is in the P&L and accounted for.

And then finally on surplus capital distribution, the question that you had was primarily about timing I think wasn't it Rohith. So in answer to your question yes, we will continue to look at that at year-end just like we always have done. And that is simply because it allows us just to take stock of the performance of the business, of the outlook, pending regulatory questions and so forth. Of course when you get into the average performance during the years if you like, that shouldn't really make much difference in terms of the flow of capital coming back to shareholders. It is only when you get these discontinuities like we have had in the last year where the average during the year versus the year-end considerations really makes much difference. Once we are back into the flow of things, as we expect to be with regular dividends, regular buybacks, whether you take stock at the end of the year or make your decision then or whether you do it twice a year it really shouldn't make much difference to the pace of overall flow as it returns to shareholders.

Rohith Chandra-Rajan
Thank you. Sorry could I just come back on the middle question, just on the capitalised expenses. So the capital impact and the P&L impact are different. Obviously it is just the depreciation that goes through the P&L. But if you are capitalising over three years £1.8 billion, that directly impacts your CET1 capital. Sorry so just to understand 150 basis

point average annual capital generation includes over three years £1.8 billion or 80 basis points of expense capitalisation?

William Chalmers
Yeah that is right Rohith you have understood me correctly. If we have cash impact that goes straight to capital. If you have an impact that is split between an expense and a depreciation item, that impacts the P&L differently as you have observed. The fact that we spend £1 billion in one year doesn't matter how it is accounted for, it affects capital in the year in which we spend the cash.

Rohith Chandra-Rajan
Okay, thank you.

Question 2 – Omar Keenan, Credit Suisse
Hello, thank you for taking the questions. Can I please ask two questions on the funding and capital contribution to the net interest margin. I just wanted to ask a follow-up question on investment and depreciation. So on funding and capital, so that contributed 4 basis points to NIM over the course of 2021. Can you please talk about the MREL position and whether you think that would allow further funding efficiency and lower absolute wholesale funding that could contribute towards the NIM over the course of the year. And I just understand that there have been a few liability management exercises. So if you could perhaps also talk about the non-common equity dividends, so that we can just make sure our models reflect the right number?

And then just on costs, I was trying to get a BAU and investment and depreciation split of the £8.3 billion in 2021 and the £8.8 billion in 2022. Is that something you could give just for the models, thanks?

William Chalmers
Okay, well let me answer the first question first Omar and it may be that Cecile will want to add one or two points onto that. But if you look at the impact of the funding and capital contributions over the course of 2022 looking forward, actually maybe I will start with a step backwards. We did get some benefit from lower funding costs overall during the course of 2021, but looking forward in 2022, we expect that to be also reasonably significant. It will be from a combination obviously of deposit funding benefits from cost of funding, bank base rate changes and the like. It will also be from effectively lower capital costs off the back of our capital structure, and that is simply because issuance costs have gone down. It is also because, as you rightly pointed out, we have had some liability management exercises, the cost of which are getting taken account of in the restructuring charge. Then as you take care of more expensive debt in the capital structure through those liability management exercises, you indeed get some funding relief and therefore some margin relief off of that in the future years. So we do expect that to be a component of the above 260 basis points guidance that we gave for the margin in 2022.

The only other comment I would add on that, before perhaps handing to Cecile to see if she would like to add, is simply that a couple of those liability management exercises, as you saw, took place in the fourth quarter of last year. You'll have seen some impact, I am not quite sure whether we actually disclosed the full liability cost of the exercise. But you will have seen some costs from that in the restructuring charge that was taken in the context of Q4 2021, which in turn will see some benefit for the margin therefore in 2022 looking forward.

Cecile, before moving onto BAU investment depreciation, anything you would like to add to that?

Cecile Hillary
Yes I can add a few points. The first one is indeed around our funding mix. Clearly right now we have, as William was mentioning, £30 billion of TFSME that has been drawn, and obviously a very large amount of deposits since the beginning of the current crisis, £65 billion of additional deposit, so obviously that counts. So, in terms of how we are looking at this going forward, as William mentioned, this year is still reasonably light in terms of the issuance, about £5-6 billion, that we are planning for the HoldCo and subsidiaries. Going forward, we will target £15-20 billion of issuance. Not all of it is going to be at HoldCo, not all of it is going to be MREL. Some of it is going to include capital, now we are guiding towards levels of around 2.0 per cent for AT1 and around 2.5 per cent for Tier 2, just to give you a sense. Notwithstanding the fact that TFSME will mature between 2025 and 2027, we are going to be prudent in the way that we repay over time. The second thing on MREL, our MREL ratio is obviously fairly high right now on the transitional basis we are at 37.2%, on a fully-loaded basis it is about a percent point lower than that. Clearly that compares with requirements in terms of MREL of around 27.7%. We are not giving, and we are not guiding, towards a specific buffer on the MREL side, but there is a buffer, and it is clearly right that we have quite a large amount of MREL which over time will come down. So these are really what I would say.

On the liability management side, the liability management exercise that we have done, we are really guided by regulatory reasons. I mean it was really the first to decrease stock of legacy capital and that obviously was done in conjunction with continued dialogue with the PRA, as you can imagine, and with our UK bank peers. We are not giving the impact of liability management, as you well know, it is a bit difficult to figure it out from the outside given feedback from the swaps and hedging. But clearly we have looked at it from an economic perspective as well, as you would imagine.

William Chalmers
Thank you Cecile. Omar just coming back to your second question on investment depreciation BAU expenses. In 2021, as you know, we had an overall cost base of £7.6 billion. Within that operating costs, if you like, of around £5.4 billion, investment about £0.6 billion and depreciation about £1.6 billion. So that is how the £7.6 billion is made up in 2021. When we roll the clock forward as it were to 2022 then as you know, we committed to BAU costs staying stable during that time. There are two blocks, well there is one block for BAU costs which is the combination of the £7.6 billion in the previous year plus the £0.5 billion of previously below the line charges moving above the line, plus as you know the fraud expenses of £0.2 billion. That is what makes up the £8.3 billion in total. Then to add to the depreciation in 2022, or rather the capital expenditure charge I should say in 2022, you can roughly take 60 per cent off the incremental £1 billion that we are spending on the investment portfolio. So that is a further £400 million. You then as a final component see the combination of Embark and Citra coming into the cost base in 2022, which is a further £100 million. So you total up the £8.3 billion plus the £0.4 billion, plus the £0.1 billion that I just outlined for 2022 and that equals the £8.8 billion that we were talking about on Thursday. You can then roll that forward into 2023, similar logic applies for the expense charge for the incremental £1 billion, plus you have obviously got £100 million of the previous year's depreciation charge, or thereabouts, coming in. Plus, you continue to have Citra and Embark but then you are also taking out IFRS17. So again the logic applies in the same way as you roll forward into future years.

Omar Keenan
That's great and that is very clear. And just as a quick follow up. So the £429 million other equity dividend, is that still a good figure going forward?

William Chalmers
The £429 million other equity dividend, yes I think it is roughly a good figure. It is not going to change terribly much. Cecile please shout if you want to add any further comments, but it is pretty close yes.

Cecile Hillary
I agree.

Omar Keenan
Thank you.

Question 4 – Pearlie Mong, KBW
Hi it is Pearlie Mong of KBW thanks for taking my questions. Just two, first on software impairment. So I see you have taken a £400 million write-off on software and given that historically you have always spent more than you have capitalised. So that £400 million software impairment, is that something that is going to be more of a regular feature going forward? So that is the first question.

And the second one is actually more on the strategy. So I see that you are trying to expand your mass affluent offering. I am just very broadly asking why you might think it is a good time to launch this product because obviously given cost of living prices, inflation etc. people might have less disposable income, and some of the retail trading platforms like Hargreaves have seen fairly significant drop off in activity levels. So just how much of what is in your plan is what we should be able to see in terms of normal growth and how much of it is cream in terms of if market is supportive?

William Chalmers
Thank you Pearlie they are both good questions. In terms of the first of the two, the write-off of £400 million. That is not recurring, so we would not expect to see that number reappear in 2022 or for that matter as far as we are aware looking forward. If I just take you through the rationale for it. The software write-off is essentially coming from the change in technology that we are deploying, so in the past as you know we shared technology R&D with you as part of our restructuring costs for 2021. And that has resulted in a number of conclusions including the move to cloud, including the obsolesce of certain parts of our existing systems. As we have embedded the technology plans into the current strategic plan, so we have had an attestation exercise which has allowed us to scrutinise those parts of the technology platform that frankly don't make sense in that new setup and/or have, if you like, passed their moment of impact. So a good part of that write-off of £400 million is accounted for by that, probably about two-thirds of it maybe three-quarters of it is accounted for by that process.

There is a second component of that technology write-off which is around small immaterial items, where historically we have taken an approach whereby we would seek to put them on the balance sheet and have a depreciation charge or an amortisation charge I guess associated with them. We have looked at that practice again, in conjunction with the appointment of our new auditors as well as obviously the strategic shift that we are going through. And also looked at what other corporates have done and other corporates typically take a materiality threshold before they apply those types of depreciation or amortisation charges. So we have moved to that practice as a result of those changes. That is probably about 25%, just over, of that £400 million charge. So it is a smaller part of it, but it is a part of it. We have brought that now into our capitalisation policy whereby we effectively introduce a minimum level of spend before we capitalise.

What all of that means if you add it up, is we have taken this view of the technology base in conjunction with the new strategy. The write-off comes from that, and therefore I would not expect this to be reappearing in our P&L next year, the year after etc. I wouldn't rule out that there may be some point in future strategies, in future years where the technology base is scrutinised again. That won't be my concern any time soon, but that is some distance off in the future if it were to ever recur it would be in that fashion. So hopefully that clarifies on the software point.

On the mass affluent point, Pearlie, again it is a good question. A couple of points that I would make in conjunction with that. One is you are absolutely right that the mass affluent component is one of our signature strategies if you like, one of our big initiatives going forward and therefore we have spent a lot of time deliberating what we think is going to best suit our customer needs and indeed what we have to offer in this respect. It consists of two or three components, one is we are targeting, with the mass affluent offering, a part of the customer base that while it will be affected just as everybody is by some of the cost living changes and so forth, will be relatively perhaps slightly less affected than other parts of the overall demographic. So I think this is a customer base that we see as being relatively resilient to some of the changes that are going on in the outside world, not to discount them at all, but just to put them in that context.

The second point and perhaps as importantly, what are we offering here. What we are offering here is essentially almost a two prong component of banking services oriented towards mass affluent needs. At the same time, also savings and deposit services again oriented towards mass affluent needs. So if I take the first, the banking services, we will be looking at things like larger size mortgages for example. We will be looking at things like deposit taking facilities for example. And we will be delivering it in a way that is facilitated by stronger, more thought through, often more digital customer journeys again with personal contact where appropriate. That is a market which we have not addressed in full. We have tended to adopt a relatively standardised approach to many of these product offerings and the mass affluent therefore have been less effectively catered to by us here in terms of our product offering and our services. At the same time as you know, we have also bought Embark and Embark sits alongside Schroders Personal Wealth, part of our overall wealth offering. And we will be looking to develop that Embark offering as part of our direct consumer wealth offering, often self-directed, often as part of a composite of both insurance and banking activities that we can propose to the customer.

The final point, Pearlie, is we will be looking to bring them together in an integrated offering. That third component is going to, not surprisingly, take us longest to get to. But bringing together, to a customer, their banking needs and their savings offering in one coherent and integrated format is key to what we propose to do going forward. So in that context, we see it as quite differentiated to what else is out there in the market and indeed something which, because of the business model that we operate, we should be very well equipped to offer. It breaks off the past, it will take us some time to build, but we feel very confident about putting forward a differentiated offer based upon a) banking, b) wealth and c) integrating the two of them.

Pearlie
Okay that's great, thank you.

Question 5 – Robert Noble, Deutsche Bank
Thanks for taking the questions William. It is just a follow-up on the investment spend which others have asked as well. What is the split between intangible and tangible investment that you are capitalising? And is there any difference as to how we should think about that impacting capital and, linked to that, what should I expect for the intangible asset growth going forward?

William Chalmers
Thanks for that question Rob. The intangibles, I think, have broken out in the annual report and you will have seen those in the notes that we produced on Thursday. But in response to your question around the new initiatives in particular, which I think is where your question is getting at, the significant bulk of the £3 billion spend that we will be doing is intangible by its very nature. It is going to be spent on the strategic initiatives as outlined, whether that is digitisation of the SME bank, whether it was what we were just talking about around mass affluent, better consumer and indeed intermediary propositions; to a significant extent, also the large corporate CIC offering. The bulk of that £3 billion incremental spend over the course of three years, indeed £4 billion

over the course of five years, Rob, is intangible. Therefore, it will be to the point that Rohith was getting at earlier on, it will go straight through the capital base in the year in which it is taken, in the year in which it is spent if you like. Leave aside the accounting. That will not necessarily be 100% Rob, but I think if you take that as your guide you are not going to be far off.

Robert Noble
Ok, great. Thank you.

Question 6 – James Invine, Societe Generale
Hi there good afternoon, thanks for taking my questions. I have got two please. The first is on the mortgage strategy and I think you have outlined it very clearly. I was just wondering, is there a minimum market share that you think is necessary to maintain your franchise? So if pricing gets really aggressive, is there a point at which you just have to grin and bear it because you don't want to see your number one franchise eroded?

And then the second question is on the structural hedge. In the past when swap rates got very low we have seen you stop rolling the hedge. Now we have seen swap rates moving around quite a bit recently. If they get, in your view, very elevated would you do the opposite and over hedge maybe?

William Chalmers
Thank you for that James, on both counts important questions. For the mortgage strategy, you do see us stepping into and stepping out of the market at certain times. You also see us stepping into and stepping out of certain products at certain times as well. So whether they are re-mortgaging products, home-mover products, 5 year, 2 year, high LTV, low LTV. It is a very tactical position that we take often enough on the mortgage market around which products we think the margin is in and which products at any given time we will take a view on and write or alternatively hold back on. That is at the day-to-day tactical level. Stepping back and answering your question around, having said all of that, is there a minimum market share that we will take? We saw in Q4 that we took about £0.7 billion of net open book growth. That equated to a market share of around 17% in Q4. That is at the low end of what we have seen over the course of the year before that really, where as you know we were a nudge up from that. Obviously, in the context of a more lively mortgage market, our overall open book growth was substantially more than that. I don't think I would put a specific number on the minimum market share that we would take, but on the other hand, in the interest of ensuring shareholder value, we will not shy away from moving market share up and down over any given quarter. At the end of the day, James, we are a major provider in the mortgage market. We have scale. We ought to be able to compete on terms that are advantaged verses anybody else and I hope therefore over the longer-term, you will see us have very solid market share. What that means for any given quarter will depend upon the pricing that we see available in the market at that quarter. We are not going to be held on a week by week basis, or frankly to a degree even a month by month basis, to a given established market share that we feel we most religiously adhere to. But as I said overall on average, you are going to see numbers that are not dissimilar to what we saw over the course of 2021 on average.

In terms of the hedge, we have managed the hedge as you know for two reasons. One is to ensure earnings stability for the business and two is to ensure shareholder value for the business. That does lead us to, you will have heard the term before, dynamically manage the hedge. It means that we are not engaged in a constant roll as your question alludes to. As you rightly point out, what that has meant in the past, particularly in the course of 2020 is in a very low rate environment, we have gone relatively shorter on the hedge, simply because you don't get paid for investing in the curve. Therefore why, if you like, tie yourself up for a long period of time if you don't actually get paid for that, and that has worked out well. That has worked out well in terms of the returns that we have managed to get from the hedge, as we have moved into slightly steeper curves and you have seen that evidence in the 2020 hedge performance and indeed you see it evidenced in the years ahead as we invested in to rising rates over the course of this last year.

When we look forward, if we see periods where rates look very attractive and we think for some reason there is perhaps some market discontinuity there, within reason, we will write more heavily into those periods of time or we will accelerate any given hedging that we have to do within any given three month, six month, twelve month period. We will accelerate it to a degree within periods where we think, as I say, the market is not necessarily reflective of how we see it might evolve.

Having said all of that James, I think it is important to say that this is a very carefully risk managed the hedge is and therefore we will only do it within certain tolerance limits. And as you know, we have very strict parameters within which we measure the hedge in terms of the size of it, in terms of the amount that we would write in any given period. That is all governed through, ultimately the board, but in between ALCO and our Group Executive Committee. So overall we might move around at the edges. Having said that, we do take a very consistent view of risk managing the hedge in an appropriate way. The default position is neutral, meaning that we are fully hedged, but it won't always be that way, it will ebb and flow a little bit depending on how we see the market.

James Invine
Lovely, thank you very much.

Question 7 – Chris Cant, Autonomous
Good afternoon, thanks for taking my questions. Could you tell us what your Business Growth Fund (BGF) gain was in 2021 please? I am just trying to unpick the numbers you have given us in terms of the equity investments side of the business and I know you have flagged Lloyds Development Capital (LDC) was about £100 million above normal. But I think there is a BGF gain in those numbers as well. So if you could quantify that for us that would be helpful.

And then in terms of other income and just understanding the development there, how much annually should we be expecting in terms of insurance one-offs? So they are not really one-off in nature, I appreciate that it is a normal part of the business, but in the past you talked about starting from a conservative position and there being a bias to those being positive. How much should we be thinking about there? I am guessing 2021 is a bit elevated to what you might normally expect, but any colour is appreciated.

And then finally on RWAs, you haven't given us 2026 guidance on RWAs and I am guessing that is partly because of uncertainty around exactly what is going to happen with Basel IV or 3.1. What is your latest thinking, please, on the impact on the Group from Basel IV at the point at which it is applied, accepting that we don't know exactly when the PRA is going to require you to apply those rules. Thank you.

William Chalmers
Thank you Chris. Right just taking each of those in turn. BGF, as you say, is part of our overall equities business. That, collectively, had a good year during the course of 2021 in ways that probably exceed what we would expect to see it coming through with over the course of projected future. So to finish off on LDC, I will come to BGF Chris, but to finish off on LDC, we think that LDC had earnings that were probably about £100 million in excess of our run-rate for LDC. So had earnings that were about £500 million, we would see a run-rate of LDC of more like £400 million going forward. So that is that piece.

For BGF, we haven't put a precise number on it Chris, but I mentioned at the half year that we saw BGF as having made about £100 million as of the half year. I think it did about as well again in the second half. Having said that though, it is a little different from LDC in that we would see some decent component of that number going forward. So I think probably three-quarters of that 2021 performance should be repeated in 2022. And then maybe half or thereabouts should be repeated in 2023. So I think you would expect to see somewhere between 50-75% of that 2021 performance within BGF to be repeated again in 2022 and in 2023 looking forward. So LDC has recurring earnings around £400 million, BGF we expect to see having recurring earnings too, albeit not at the size and scale we saw in 2021.

In terms of insurance one-offs, we had an annual basis review in the fourth quarter which as you know gave us about £80 million through a combination of mortality, expense and persistency, those three things. To a degree, also actually improved modelling. The expectation that I would have going forward is probably a little below that on a run-rate basis for insurance AVR and the reason I say that is because, out of that £80 million, you have probably got about £30-40 million or so of effectively model improvements. So I think you wouldn't expect that to come through consistently on a year on year basis. I think the bias would be more like in the £50-60 million range or so for insurance, i.e. taking out the model improvements that we saw in 2021. Having said all of that Chris, before moving onto your third point, by their very nature these AVRs, they fluctuate. They obviously go up and down, and we can't tell you what next year's mortality experience will be for example. Or for that matter, necessarily some of the expense changes that might be in place. So just take that guidance, but take it with a little bit of caution because of the volatility that you see in those numbers.

RWAs - Basel 3.1. As you know Basel 3.1 has been a bit all over the place over the course of the last year or so. And unfortunately we have seen a number of delays and uncertainties come into play. I will make one general comment and then comment a bit more specifically. The general comment is that we see Basel 3.1 as having no net or no material net impact on the business. Why is that? It is because, essentially stepping back, some commercial corporate benefits more than compensate for some of the retail headwinds that are likely to be caused. Now this is talking about the Basel 3.1 that is ahead of us in the next couple of years or next three to four years depending on when the PRA decides to introduce it. It is not necessarily taking account of the flaws that might appear in the 2030's which feel a long way off, number one, and are hard to at this point put too precise a number on. But if you look at what is coming down the pipe for 3.1 in the course of 2024, 2025 whenever the PRA choose to implement it, essentially what you see is some foundation IRB benefits that we will receive. And so specifically within that, a reduction of the scale up calculation within RWAs, number one. A reduction in the credit conversion factor for undrawn facilities, number two. A reduction in standardised loss given defaults, number three. Those are areas where we benefit, simply because we have got in place foundation IRB, risk-weighted asset metrics right now. It is painful while you have got those, versus others who have more sophisticated RWA treatment. But the benefit is that when these changes come in, we are somewhat immunised from them. On the other hand, we have some headwinds, the CVA removal of the corporate exemption for example. The removal of the SME scalar for example. Having said that, you have probably seen what Europe has done on these two items and essentially it has accommodated them and taken a very accommodating stance towards them. So in our numbers they are headwinds. But if the PRA follows Europe they will not be and therefore you might see a net benefit from FIRB viewed as the aggregate.

I mentioned earlier on the output floor, that may or may not come in, is a lot further off; people are now talking about the 2030's. You know that is another discussion, perhaps for another day. The comments that I am making around Basel 3.1 right now are around a set of changes that are coming within the next two to three years depending on PRA times of implementation. If we see them follow Europe, then I think we will get a net positive out of the 3.1. If we see them following what they have previously described, i.e. not following Europe, I think it is net neutral.

Chris Cant
That is really helpful, thank you.

Question 8 – Aman Rakkar, Barclays
Hi William, a couple of questions. First one was on the strategic revenues. From the £1.5 billion revenues, I understand half of it comes from NII and half from OOI. Can you help me understand a little bit more around the NII component of that and what are the kind of balances and NIM that might be coming on as part of that? I guess, if I was to combine it with your comment I think the other day, that asset growth is low single-digit, it seems like most of that asset growth is actually going to come from strategic initiatives, which suggest virtually very minimal growth in your BAU business. Is that the right read on that strategic revenue guide?

Two would just be on headcount. I note actually your headcount fell pretty materially in the year and rather curiously fell in some of the divisions such as Wealth and Insurance, which I thought would have been part of your strategic growth. Is that a catch-up on Covid, when it might have been harder to get headcount down, is that a sustainable run-rate going forward? I mean, how are you guys thinking about FTE in 2024 and 2026, is it going to be meaningfully lower?

And sorry, just one final one if I may, given we have Cecile on the line. Just around your rate sensitivity, I note it came down a touch in the quarter, I wasn't quite clear why that happened and as part of that can you just remind us how much of the year 1 benefit is managed margin versus structural hedge please? Thank you.

William Chalmers
Yes Aman, sorry I was just scribbling down the first two questions you had there before you got to your third. Would you mind just repeating the third one Aman so that I just get it down correctly?

Aman Rakkar
Yes it is just on rate sensitivity, it looks like it came down versus Q3. Not clear why.

William Chalmers
We can certainly answer that. Strategic revenues Aman, first of all, and indeed NII is a general matter. When we look at the balance sheet going forward, we have a picture of total customer lending growth of low single-digit increase on a kind of compound annual growth basis. So low single-digit year in year out would be on average about right. That is, as you say, significantly driven by the performance of the strategic initiatives, and referring back to earlier on actually, on things like mass affluent with for example the expectations around large size mortgages for people who are appropriately credit scored for them. Or alternatively initiatives around the relationship business or the intermediary propositions businesses that we have. Those strategic initiatives do drive a significant part of the balance growth within the business. I think I also mentioned by the way on Thursday that the RWA growth is roughly half that, just to give you some metric, I know you didn't ask that but that is a further component. There is no doubt that in some areas, the benefits are coming from pursuit of the strategic initiatives, and again the mass affluent mortgage proposition might be a good example. But I think at the same time it is a bit of a false distinction in other areas between BAU on the one hand, and strategic initiatives on the other. The reason I say that is because a fair amount of the strategic initiative spend in propositions for example, or even for that matter in relationship, is being driven around what you might consider to be fairly BAU products. What we are doing is we are effectively readdressing the way in which we approach a customer, readdressing the way in which we price a product to a customer, and readdressing the journey that that customer might undertake for any given product. So what you end up with, is an unsecured product or alternatively a mortgage product or whatever it might be, being part of that overall customer proposition, but the investment is in effectively improving that overall flow. The sum of that in totality is the low-mid single-digits growth CAGR within the asset base, within the customer lending base, that we expect to see. So that low single-digit covers both SI and covers BAU. And I am not sure it is that easy to distinguish between the two.

On your second question around headcount, you are right headcount has come down in 2021, and indeed it has continued to come down actually over the course of 2022. A couple of points that should be made in that. One is, that is partly a function of design. As you know, our organisational design approach is a key component, a key plank of our overall cost management approach as an organisation. It is one of the tools that we deploy for our efficiency objectives. It is also partly a function of the fact that the hiring market is relatively tough, so where you have positions that you would like to fill you can't always fill them with the speed and pace that you previously could have done. Therefore hiring tends to be a little bit slower in the market that we are in today.

There is a third component of it, which I am sure is generically called the Covid effect for want of a better word, which also affects the FTE base. What does that mean going forward? I think going forward it means that we will see FTE continuing to reduce, in line with our organisational design imperatives, i.e. through our own deliberate organisational design approaches. Also, we will probably find the recruitment market a little bit challenging just like everybody else is right now. Having said that, the silver lining if I can call it that, to that particular piece, is that out of that necessity we often find savings. We often find divisions or areas of the bank for example, that will ask for a certain number of FTE, that will struggle to find the FTE in the right spots at the right time, that off the back of that, figure out different ways to approach problems. As a result you get an FTE saving that you did not necessarily expect in the first place.

But in short and in answer to your question Aman you are looking at an FTE count that will go down going forward, perhaps a little bit slower than in the past, because of the effect of strategic initiatives and the investments, but nonetheless gently down over a period of time would be about right.

Then finally on rate sensitivity, and Cecile may want to add to this, in short the rate sensitivity has come down simply because the hedge has been deployed over the course of Q3 to Q4. And so it is nothing more complicated than that really. As said, just the hedge has been slightly more fully deployed and therefore the sensitivity to a 25 basis point rate rise is already built in to the value of the hedge today because we have effectively taken the full position as opposed to being out there, and therefore investable in a higher rate environment. And it is pretty modest I think isn't it, the difference, but that is responsible for the difference in hedge sensitivity that you see between Q3 and Q4.

Aman Rakkar
Okay, great thanks.

Cecile Hillary
I haven't got much to add, and indeed if you see some of the NII sensitivity related to the structural hedge, naturally it is rolling off. All of this here relates to our management and our assumptions have been very conservative from Q3 to now, as William says, the main impact has been really just the expansion of the structural hedge.

William Chalmers
Yeah, it is perhaps worth underlining that point actually, that Cecile has made. The assumptions have not changed between Q3 and Q4. We took a view that it was better just to keep things as they were, given the fact that hopefully Q3 was clear and we'd stick with it in Q4.

Question 9 – Alvaro Serrano, Morgan Stanley
Hi good afternoon. I have got two questions. It is really all around the rate sensitivity and the structural hedge. Just on the deposit beta, can you confirm, because I think you assume close to 50 per cent beta in your plan. I think you mentioned it last week, but just wanted to confirm that.

And then on the size of the structural hedge, as another follow-up from an earlier question, obviously the mix of in-year deposits is improving, more current accounts, which presumably lends itself to a bigger structural hedge. But on the flip side some of those balances in the low rate environment, maybe call it fake current accounts, in the sense that it is lazy money left around that will shift quickly to term deposits. I don't know if you can give us a flavour on that issue and if we should expect a big shift or not? And you have already alluded to the modest increase in contribution, but I am wondering if it can be more than modest if some of those deposits become stickier. Just a bit more food for thought there. Thank you.

William Chalmers
Thanks Alvaro. In terms of deposit beta, we have assumed roughly 50 per cent over the course of the planned period. It is worth saying maybe a couple things. One is the sensitivity obviously does include a 50 per cent, just straight 50 per cent, assumption in it. We have two points to add to that. One is that the extent to which we pass on interest rate rises to depositors, there is over the course of the plan as interest rates gradually inch up over the course of the plan, the start point looking backwards is that we have

passed on a lot less than 50 per cent in common, I believe, with most other lenders. As we look at this stage of the cycle, that continues to be more or less the case and more or less the expectation. Now we will see how that fares. But at the moment the expectation is that the pass on is significantly below 50 per cent to depositors simply because the balance sheet is very liquid, simply because that is the way in which competitors are reacting and typically because you know customers gain benefits in other places e.g. mortgages. So that continues to be the case. I suspect that will continue to be the case for much of this year and therefore the 50 per cent assumption feels like a relatively conservative assumption for how much we are likely to pass on anytime soon. So that is it on deposits.

When we look at the structural hedge, coming to your second question Alvaro, the size of the structural hedge we have kept constant at £240 billion. That is despite continued build up in deposits. So if I mention numbers, which I am sure you are familiar with, we saw overall increase in retail deposits of £3.8 billion in Q4, personal current accounts within that of £2.7 billion within Q4. Retail of that £2.7 billion was about £1.9 billion, commercial banking about £0.8 billion. So continued deposit growth in Q4, absent the commercial management points that I mentioned in my comments on Thursday. That commercial deposit base is frankly less hedgeable because it is shorter notice, it moves more quickly. So the optimisation, as we described it on Thursday, of the commercial deposits, doesn't make a great deal of difference to the overall hedgeable balances that we have. What does make a difference is the retail, the generic PCA growth and particularly within that, the retail component of it. That is a much more hedgeable deposit flow. Nonetheless, we kept it at £240 billion for the year, consistent with Q3. The reason we kept it there is just to take a look at how deposits behave over the course of the first three months, six months of this year. At the moment at least, we have a very significant buffer in the context of the hedge, so if I put some numbers around that. Year-end 2019 we had a buffer of around £9-10 billion. Today, as of year-end 2021, we have a buffer closer to £40 billion. Now, if we see those deposits stay with us over the course of the first three months, first six months of this year, we will look again at that £38-40 billion and just figure out whether or not it is appropriate to increase the size of the hedge in that context. We are going to monitor the behaviour, we are going to look at the capacity in the course of the first half of this year. It may be Alvaro, that some of that money that has come to us over the course of 2021, goes into term and therefore becomes rate sensitive, number one. It may also be that some of that money is spent if we see a recovering macro in the economy. But we expect that either of those two, either money that goes into term or alternatively the amount that is spent in the context of recovery macro, will be pretty modest, simply because you look at the dynamic about customer expenditures and it simply can't be numbers that are anything like the type of buffers that we have built up. Otherwise, you have GDP growth that is exponentially faster than what we are forecasting.

My expectation as we sit here today Alvaro is that a decent chunk of those structural hedge eligible deposits, that circa £40 billion buffer that I mentioned, will probably stay with us and we will look again at whether or not any of that should therefore feed into the £240 billion in Q1 and again in Q2 and come back and let you know.

Alvaro Serrano
Thanks William.

Question 10 – Fahad Changazi, Mediobanca
Good afternoon. Could you explain the rationale of having an annuity business under the new strategy? I believe it was mentioned once by Charlie. And also perhaps give an idea of the cash generation of the annuity business, or perhaps qualitatively give an idea of how much of the insurance dividend is financed by the annuity business? Thanks.

William Chalmers
Thanks Fahad. I will probably answer the first one of those two and perhaps less so the second one. In terms of the rationale for the annuity business Fahad, it continues to be a pretty important overall business for us for a couple of reasons. One is as you know the business breaks down into essentially individual annuities and then secondarily bulk annuities. We have written quite a lot of individual over the course of 2021. We have not written much in the way of bulk, and that is simply because the bulk market, as you probably know Fahad, has been very competitive. It has been competitive off the back of low rates and therefore trustees were just not that interested in locking into bulks at that time.

Dealing with each of those two markets in turn, the individual annuity business is an absolutely key part of our overall proposition from a customer point of view and we have been generally pretty successful in that over the course of 2020/21 and that continues to be the case. I would expect us to continue to write that in size as I said, as a component of our overall retirement proposition to our customer base. Indeed, it is pretty key as we look to build the accumulation part of our overall insurance proposition. Embark is also a component of that.

On the bulk side, we see bulks as being twofold. One is potentially at least offering us a decent return, albeit the last year has not done so to be clear and therefore we have stepped back and not written an awful lot. But nonetheless, in a normal market if you like, particularly as rates start to rise, we do think trustees are starting to take a look again at bulks and indeed we do see bulks as potentially offering us the opportunity to write business in excess of our cost of capital and therefore enhancing returns to shareholders. We also see bulks as potentially playing a role in the overall proposition that we have. And so if we can source illiquid credit from various parts of our banking proposition, whether that is commercial, whether that is Citra, whether that is other aspects of our banking proposition. Those assets in turn become the illiquid component if you like of the overall bulk strategy i.e. they provide the credit side of the liability that we are writing. We think we have got a competitive advantage therefore, in sourcing this credit, in holding it in the insurance company. That in turn should allow us to maintain a competitive advantage when we write a bulk to customers and indeed when we see the returns come off the back of that.

So I think both individual and bulks have a place in our business going forward. As said, bulks will be disciplined and we will not write where we don't think it makes sense. There is a separate angle to this, which I am sure you are getting at, partly in your question, which is the IFRS17 component of bulks. To be honest with you we have never really looked at it that way. I have made sure that the business does not write a bulk simply because you get an IFRS4 upfront benefit. Those bulks have always been priced off of long-term returns on a proper cost of capital basis and hence the reason why we have been pretty light in the market the last couple of years.

That addresses the first of your questions. In terms of cashflow, hopefully some of my comments about returns, particularly in the bulks business give you some sense of the cash that we expect to get at least on a return basis from any given product. It is worth just while we are on the subject of insurance, pausing briefly on insurance. You will have seen in the insurance solvency returns that they had a 191 per cent gross solvency position, which was pre-dividend. Likewise, you will have also seen that after dividends and also after our buying of Embark that went down to about 169 per cent. There are also some transitionals coming out of the capital base, that probably knocks off another 8-9 per cent or so off solvency. That still looks a very comfortable solvency position. We kept it there this time around because of the uncertainties in the environment. But I think that solvency position after letting off dividends number one, Embark number two, transitionals number three, it is probably circa 10 per cent ahead of where we would like to run the business on a go forward basis. I know this is not exactly the question that you asked Fahad, but it comes down to the solvency cash flow dividends and insurance company. I guess what I am saying is that we got a dividend last year, I think that number might have been published. We think the business is still pretty strongly capitalised, in fact over capitalised, versus where we would expect to manage it over the medium term.

Fahad Changazi
Thank you very much.

Question 11 – Jonathan Pierce, Numis
Hello there, thanks a lot for doing these as well, the detail we get out of it is really very helpful. Three questions. One is coming back, sorry, to the software charge. You have been capitalising about £1 billion of software intangibles for four years now, yet if I take out that impairment, last year I think the software charge that went through the P&L was only about £500 million still. It sounds like the intangible capitalisation is probably going up from £1 billion this year in total. At what point will we see the amortisation charge in the P&L get up to £1 billion plus? Presumably that is going to happen quite quickly and that is where quite a lot of the cost growth is coming from over the course of the next few years. So the direction of the software amortisation charges is question one.

Question two, just for clarity on this 50 per cent pass through, what exactly are you applying that to, is it every single interest bearing deposit within the bank? Which I guess is probably about £300-350 billion. Is that what that is being applied to?

The third question is on the mortgage refinancing risk, as we go into the latter part of this year and next year, which you flagged to some extent last week. The maturities that were coming off last year of 150 basis points. When I think about that later this year obviously we have got five year business coming off from five years ago, which looks like it is probably slightly lower spread than the average back book. But then of course, we have got the two year business from two years ago, which is a much, much higher spread than the average back book. It would be helpful if you could give us a sense as to where you think that business will be rolling off from as we get into later this year and early next year, because on my map we are getting up to 170-180 basis points. We do go through a period of very significant mortgage refinancing headwind later this year and next year. Is that right?

William Chalmers
Thanks Jonathan, let me take each of those in turn. On the software intangible, a couple of points are worth making. One, as I said, is that much of the £1 billion spend that we do as an increment to the existing business. So £3 billion over three years, call it £1 billion this year, £1 billion next year, £1 billion the year after. Much of that spend, as said earlier on, is effectively on intangibles and so that will go into the depreciation/amortisation line and act to effectively inflate our intangibles over that time period. Now, essentially that is about 60 per cent capitalisation rate. That means that we take the charge obviously of the 40 per cent in one year and then we are looking at the remaining 60 per cent being taken out over the five years average useful life thereafter. So

call it about £1 billion, you are looking at about a £400 million charge year one, you are then looking at about £120 million to run off the remaining £600 million over the course of the five year useful economic life for that piece of software. Hopefully that answers the question in terms of the build-up in the software intangible as a result of the new strategic initiatives.

Jonathan Pierce
Yeah, thank you.

William Chalmers
It is the case, just as a point of detail on that, that the 60 per cent is slightly lower than you will have seen from previous years in terms of our overall capitalisation rate being a nudge above that. Caused by a couple of different things, one is the above the line, below the line switch which is making a modest difference. And then two is the nature of the investments that we are making, but hopefully that gives you kind of enough to work with Jonathan.

The second point, 50 per cent pass through. That is effectively applied to the unhedged element on the interest bearing deposits. I don't think we published the interest bearing deposit number before, but it is south of the number that you gave there Jonathan. It is a substantial number. It is over a couple of a hundred billion but it is well south of the number that you said there. So we are applying the 50 per cent, just to be clear, to the unhedged element of the interest bearing deposits. The reason I stress unhedged is because everything that is hedged is obviously locked in and therefore you are not applying the 50 per cent pass through to it. That is effectively value that is in the hedge already and will roll off as the hedge matures over the forward looking years.

The third question Jonathan, mortgage refinancing risk. I won't give a precise number on this but hopefully what I am about to say will be helpful, which is you saw over the course of 2021, I think every quarter we gave you a good sense as to what the completion margins were. I think we more or less did the same over the course of 2020. So I am going to get my numbers wrong here because I can't remember well enough, but I think if you go back to the kind of quarterly transcripts you will see the completion margins for each of those quarters. More or less the fixed rate book is around 70 odd percent of the overall book. And more or less two year, five year is about 50-50 within each of those periods. So 50-50 of the 75 per cent that gives you a kind of quantum. Just check back on the completion margins, because from memory, and I stand to be corrected on this because I don't have the numbers in the front of my mind, I think it was somewhere between 150-180 basis points, 160-190 basis points, in that zone over the course of those couple of years.

Jonathan Pierce
Okay. That is very helpful, but obviously you have got the five year stuff from five years ago coming off as well, where I think the disclosure on the margins wasn't quite as good. But if we look at the Bank of England data it feels like that stuff may be slightly lower spread than the average back book, but net net it doesn't sound like you are disagreeing with the broad idea that the stuff that comes off later this year and early next year is probably going to be quite high. So the delta down to this 75-100 basis points of new business spreads is going to be very large.

William Chalmers
I think we are deliberately pointing it out because we do see this as being an important headwind in terms of the business going forward. Now we think it is going to be more than made up for by the various different components that we talked about last Thursday, but we are pointing it out because we think it is an important item for people to look at and to think about. I think on Thursday we said it was a number that was well south of two billion, but north of one billion, in terms of the overall quantum of the headwind. But that number Jonathan, just to be clear, is a number that spans the two to three year period that we are talking about here. That is a number that deals with that period of time. So again, hopefully that gives you a bit of context. It is not single year, the component number is for the whole of the year that we are talking about.

Jonathan Pierce
Great. Thanks a lot William.

William Chalmers
I think we are just running over a little bit so we might just call that time if everybody is okay with that, and if there are further questions please do let us know. Douglas, Ed, the IR team and myself, just let us know if there are further questions that we haven't got to today.

Thank you very much indeed for joining.

END

FORWARD LOOKING STATEMENTS

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