LLOYDS BANKING GROUP PLC – FULL YEAR RESULTS – SELLSIDE ROUNDTABLE TRANSCRIPT

(amended in places to improve readability only)

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William Chalmers
Welcome to everybody joining the call and thank you for taking the time. I think we gave most of our messages on our session last week and had a good Q&A at that time. So today is really just to open the discussion up to any questions that continue to be interesting from your perspective and with that I will hand over to the first person.

Question and Answer Session

Question 1 – Rohith Chandra-Rajan, Bank of America

Thank you very much. Good afternoon William. I would like a couple if I could please. The first one just on the structural hedge, we did touch on this last week, but you usually run that with something of a buffer, we heard from a couple of your peers that they will be reducing the size of the hedge going forward. So I wonder if you could just walk us through the scale of the buffer today, and in terms of deposit migration what you would need to see to reduce the size of the hedge and how quickly a change in deposits would then flow through to the hedge? That would be the first question.

The second one is just a numbers one really, just trying to square your earnings and RoTE guidance for 2023. I think me putting the two together implies average tangible equity of around £34 billion. And the start point for the year on an IFRS 17 basis I guess is around £31.5 billion. The final dividend also comes off early in the year. So taking into account the buybacks, earnings, reserve unwind etc, it looks like you would be needing something like a positive £1 billion cash flow hedge revaluation in Q1 to get to that £34 billion average tangible equity for the year. I was just wondering if that is the right sort of ball park or if there is anything that I am missing in that calculation please?

William Chalmers
Sure, thanks very much Rohith. I'll talk through each of those two. In terms of the structural hedge buffer first of all, we ended the year with a structural hedge buffer of about £25 billion, which continues to be what we carry today. That as you know is down from about £30 billion in the previous quarter which is accounted for by the incremental £5 billion that we put into the structural hedge. As we look forward, there is no particular hard and fast rule about what exactly that buffer should be. But it is worth just commenting that before the pandemic we had a buffer of about £9 billion or so. And then that ran up sharply during that time, for all the reasons that you know about. When we look at the buffer going forward we have some uncertainties in terms of how depositors will behave as we have been discussing amongst this group. So, we will be continuing to ensure the buffer is held at probably a higher level to ensure some insulation from those trends. But £25 billion does appear to be relatively high and so it is deliberately designed to cope with the period of uncertainty and £25 billion should not necessarily be taken as our long-term run rate buffer. Having said that, we are moving into a higher interest rate environment and we need to be respectful of what that might mean. In terms of how that might affect the hedge going forward, as we said on Wednesday of last week we expect the hedge to be basically stable over the course of this year and that is off the back of the deposit assumptions that we discussed with you, both outflows, churn, and also inflows in terms of some of the savings accounts. So that is the context of it. Should that need to evolve in any way because deposit patterns don't necessarily follow the paths that we expect, then we have as you know a large part of maturities in the backend of this year. We have got about £35 billion of maturities in total, of which around £30 billion are in the second half of this year. So there is plenty of capacity, both in the buffer first of all and then secondly in maturities if we need to look into that. But as said £25 billion is a bigger than run rate buffer as we see it, deliberately there for uncertainties, and is a cushion in the event that deposit trends don't play out quite the way we expect them to.

In terms of earnings and RoTE guidance Rohith, well as you know we don't give guidance on the TNAV as such but just to give you a sense of the moving parts because it came up last week and it is a fair question. What we see developing over the course of this year in terms of the TNAV as a whole, we obviously have the benefit of attributable profit which you will get a good sense of from our numbers; margin guidance, costs, AQR. So that is one benefit. Off the back of that we see a slight slide down in rates towards the back of the year as we get into expected rate cuts in 2024. That builds pension a little bit, that builds the cash flow hedge reserve a little bit too. And then netting off against that we have the dividend going out and we have buyback funds going out, albeit the latter, if you are looking at it on a TNAV pence per share basis which I know is not what your question asked but nonetheless, that will be a factor which offsets the buyback outflows. But as a TNAV expression, it is those factors: attributable profit, pension, cash flow hedge reserve, and then outflows for distributions. And I think if you are looking at those Rohith you are getting all of the key points. We do, as commented last week, expect the TNAV to be running up during the course of this year as we outlined off the back of those factors. But we don't give guidance that is more specific than that.

Rohith Chandra-Rajan
Okay. I don't know if you could comment a little more specifically particularly on the cash flow hedge and any revaluation in the early part of the year given the rates moves that we have seen?

William Chalmers
Yeah, sure. I mean without wanting to give specific guidance about exactly where the TNAV goes. The kind of factors that you have identified, the kind of trend that you have identified is not a million miles off I think where we would be. Albeit, I won't go any further than that. On the cash flow hedge reserve two points really. I think in terms of the overall trend that we might see in the cash flow hedge reserve it is probably around 25 to 35 per cent of the expectation in glide up in TNAV that we might see. But don't forget in that context there is some pluses, for example attributable profit, cash flow hedge reserve, pension. And also some minuses, for example the distributions as mentioned. But that hopefully gives you an idea. And then allied to that as you know we have a cash flow hedge reserve which as of Q4 was negative £5 billion and it has a sensitivity of about £12 million post tax for a 1 basis point increase in rates. So if you play it forward you get a sense of rate assumptions that we have made, that will give you a number that is basically consistent with the point I just made a second ago.

Rohith Chandra-Rajan
That's great. Thank you very much.

William Chalmers
Thanks Rohith.

Question 2 – Omar Keenan, Credit Suisse
Good afternoon, William. Thank you for making the time. Could I just ask about deposits and just how Lloyds have thought about the evolution of deposits in the next twelve months. So I guess sitting from the outside you know what it looks like from this earnings season, and from looking at the data your corporate deposits have been maybe a bit more susceptible towards outflows than household deposits. But you know perhaps household deposits are slower to react and we might see shifts during this year. So, I was just wondering how you get comfort really in terms of the assumption that Lloyds has made around deposits and that they are not going to shift in a meaningfully negative direction. And just as a related part of that question, should we get a pickup in the migration of sight deposits into time deposits? Is it as simple for us to think about the headwind on NIMs quarter to quarter as to look at the time deposit margin and compare it to the sight deposit margin and try to look at a mix affect that way or is it a bit more complicated? Thank you.

William Chalmers
Thanks Omar. Just to take each of those in turn. The deposit profile that we saw as of Q4, as you know we saw £9 billion in outflows in Q4, that is in the context of the year on year movement of only £1 billion in outflows. But that means that they went up in Q1, Q2 and Q3 and then down in Q4. Within that Q4 £9 billion number, as you know the bulk of that i.e. around £6.5 billion was Commercial Banking as your question pointed out. And then around £2 billion of that was in relation to Retail banking with a balance made up by Wealth. What did we see within that, within the Commercial Banking, £6.5 billion or so, we saw three things going on. One was the expected reversal in short-term placements which I think we flagged at Q3 as being an expected roll during the course of the fourth quarter. Second was we applied price discipline to some of the Commercial deposits and so where we weren't making a respectable return, particularly if they are not relationship deposits, then we were disciplined as to pricing those and that had an effect. And then finally a degree of seasonality as clients managed towards the year-end. So those were factors that affected that £6.5 billion in Commercial Banking deposits. I should add within that, Omar, that those were by their nature not typically hedge eligible and so as a result they were not deposits that would have been placed in the structural hedge and didn't cause us concern in terms of the overall balance of the structural hedge.

On the Retail deposit side we had about £1.7 billion in outflows as you will have seen in the numbers. If you look at that there is a bit of a mix effect. PCAs took the bulk of that, there was some uptick in the course of savings during Q4 as some of the repricing measures within savings came through and attracted deposits. So, the PCAs took a roughly £1.7 billion hit and because of the nature of those being PCAs those typically would have been hedge eligible. Albeit, as I say they need to be viewed in the context of PCA balances going up during the year.

In terms of the look forward as we roll forward into 2023 I mentioned the other day that we are expecting to see a deposit profile which is broadly flat, it may be modestly up but it is kind of broadly flat to modestly up, in that territory. What does that mean? It means that we expect to see PCAs coming off during the year i.e. going down during the year. But we expect that to be offset, potentially more than offset but at least offset, by rises in savings balances over the year off the back of re-pricing that we have planned and baked into our NIM. That is on the Retail side. And on the Commercial side we expect to see a little bit of rebalancing between CIB and SME. That is to say we expect to see SME deposits potentially coming off a little bit during the year as SMEs draw down on their liquidity which they stored up during the pandemic and face into a slightly tougher macro. On the other hand we expect to see CIB deposits build during the year off the back of some of our strategic initiatives, increased activities and transaction banking and so forth. And so if you add all of that together Omar that is what is giving us our picture of essentially flat, potentially modestly up within deposits as a whole.

In terms of your second question, what is the effect of all of that on the margins? If we were to see deposit changes or evolution that differs from our expectations, then in turn that is likely to be, as you say, deposits coming out of sight going into time. And I guess a couple of points to make on that. One is that we have within our greater than 305 basis points NIM guidance a fair bit of anticipated churn already built into that. I won't give a precise number, but we have a material amount of churn expected to come out of PCAs and go into time deposits already in our plans, and that is baked into our greater than 305 basis points guidance. The second is to the extent that it exceeds that guidance, then as you say essentially what we are losing there is a spread on the variable rate deposits, instead earning a margin on the time deposit. Now if that goes beyond what we already have baked into the assumptions and into the greater than 305 basis points margin, then that is essentially the trade that we would expect to see during that time. As said Omar, just bear in mind that we have accounted for what we expect to see in the context of giving you guidance and so it would have to be above and beyond that before it really gets into having an impact on the margin and beyond the guidance that we have given you.

Final point Omar is that offset against that, as we discussed a little bit on Wednesday of last week, the curve continues to move and there are some trends that are probably ahead of where our estimates are expected to be in terms of other factors on the margin, e.g. particularly base rates and forward looking curves. So what I mean by that is as you know in our base rate expectations we have a base rate peaking at 4 per cent. The market at the moment at least seems to be moving ahead of that. That in turn means that whatever balances we really invest in the structural hedge may end up getting reinvested at rates that are in excess of our expectations for the structural hedge, as we have put forward in our margin guidance and in our assumptions for 2023. So, that is a further factor Omar which needs to be played into this and it's an important one just as the deposit moves are.

Omar Keenan
Wonderful, thank you.

William Chalmers
Thanks Omar.

Question 3 – Grace Dargan, Barclays
Hi William, thank you for taking my questions. Maybe just a couple of quick ones on the mortgage market. So firstly you talked about £4-5 billion per quarter SVR coming off. How long do you expect that pace to continue for and I guess maybe another way, what do you see as the kind of terminal proportion of your SVR book as a proportion of your mortgages?

And then similarly on mortgages, you touched on maintaining product transfer share on the conference call. Are there any other maybe slight adjustments to how you are thinking about mortgage products and kind of risk appetite that we should be thinking about when modelling front book spreads? Thank you.

William Chalmers
Thank you Grace. First of all the SVR. The SVR now is just shy of £50 billion, so it is about £48 billion or so of SVR. That as you know has been rolling off at around 25 per cent in the course of 2022. There has been a reasonably consistent numerator in that equation which is to say that we have had about £4-5 billion rolling off in each of the last few quarters as interest rates have risen, number one. And as we have written to our customers advising them of alternative products in that context, as we always do, but that has carried on, number two. And so we have ourselves moved a fair number of customers out of SVR and onto fixed rate products as the interest rate environment has evolved and the SVR rate has gone up. And so it is not an unexpected development, it is one that we are a participant in. And that numerator, of the kind of £4-5 billion that I just mentioned has remained reasonably constant. I think as we look forward I would expect that £4-5 billion to remain reasonably constant going forward. It might ebb and flow a little bit around those numbers but I don't see it as terribly much changing at least in the foreseeable future. That in turn means that, what is the stopping point, as you say. It is quite hard to say that Grace with any degree of specificity but I suppose two points. One is that type of £4-5 billion run off is embedded, as you would expect, in our plans, both in terms of AIEAs where this is a headwind and also in terms of margin where likewise it is a bit of headwind as well. So that kind of £4-5 billion run rate run-off per quarter is anticipated in the course of the plans. It is our expectation that it starts to slow over time and therefore becomes a bit less of a drag as we go forward particularly beyond 2023. And that is simply because you are likely to get a base of very inert balances that just don't move. Why is that? It is because in many cases the balances of the SVR are very low. So for example £15 billion of that roughly £50 billion number that I mentioned just a second ago has balances of less than £50,000. It is also very low LTV type lending. In fact the average LTV is typically less than 30 per cent for this, that is a risk point rather than a balance point. But it is very low balances, number one, and often customers just value the flexibility offered by SVR products, number two. And so we do expect a stub of the SVR to persist going into 2024 and beyond. It is hard to say with precision what that number might be Grace. But as I said I think you can envision £4-5 billion roll off for the next say four quarters or so and then you start to get into a much slower pattern thereafter as that stub remains pretty resilient. No matter how many letters we write, some people prefer to stay on the SVR in the context of flexibility that it offers them.

In terms of product transfer share Grace, and you asked about mortgage strategy. I think we have pretty much outlined how we approach the mortgage product as a whole. I think I would highlight two points. One is that we are, as you know, engaged very much in a kind of holistic approach to mortgage strategy going forward. We talked publicly about the area of strategy in the consumer lending area, which is around trying to embrace the customer relationship in the context of the mortgage products. And that will increasingly offer us opportunities to develop relationships. Whether it is attracting deposits, whether it is being part of the insurance relationship with that customer, whatever it might be. I think that is one attribute. And the second attribute as said last Wednesday is that because of the turnover in the fixed rate book which as you know is about £66 billion over the course of the next twelve months, we do expect to see a fair share of product transfer opportunity. We see that opportunity as attractive even if the margin is a little lower for that proportion of the share. Simply because we know the customer and it is a low risk, and also because it offers the ability to develop that relationship point that I just made a second ago. So I think Grace that we will see over the course of this year an expectation that the margin is going to operate outside of the 75 basis point to 100 basis point zone that we articulated last February. And part of that at least is deliberate. To be clear part of it is just market developments, but part of it is deliberate as we seek to retain a fair amount of the maturing fixed rate book that we wrote a couple of years ago and is maturing going into 2023 and 2024.

So I think those are the two points that I would highlight Grace. I suspect neither of them are a surprise, but those are the two points that I would make.

Grace Dargan
That's helpful. Thank you very much.

William Chalmers
Thanks Grace.

Question 4 –Andrew Coombs, Citi
Afternoon and thanks for doing the call. Two questions, both technical ones and the first is in the segmental restatement. On 1 July you moved some of the SME business across to the Commercial bank from the Retail bank. I am just wondering if we can get feel of this segmental underlying trend, is it possible to provide us with any idea of the P&L attached to that segmental shift? That is the first question.

Second question IFRS 17, I think previously you said £400 million day one impact on revenues, £100 million offset on the costs. Any reason to think that will now be different and as a function of that under IFRS accounting do you think the Insurance business will be profitable this year? Thank you.

William Chalmers
Yes, thanks very much indeed for that Andrew. I'll take the IFRS 17 question and Jon may want to add on the segmental point. On the segmental point Andrew, just while I give Jon Burgess who is Financial Controller and online with me some time to think, it is a relatively modest change, Andrew first of all. But let me come back to see if Jon would like to add anything to that.

On IFRS 17 Andrew, as you say we have an IFRS 17 change which takes effect from 1 January 2023 with the transitional year being the year before that. We had an IFRS 17 change in earnings that we would have anticipated for 2022 i.e. last year that would have been circa £500 million in total. Now that was in part influenced by an unusual year of assumption changes above and beyond what we would normally expect. And so if you strip those out then we would expect to see the Insurance income to have changed more like the £300-400 million that we gave in the course of Q3 2021 guidance. So that £300-400 million is the right number to roll forward in terms of transition between IFRS 4 to IFRS 17 on a run rate basis looking forward. As you say, there is circa £150 million of cost, or thereabouts, associated with IFRS 17 that also adjust during that time. That hasn't changed, that is roughly speaking the right number to use. So coming back to the income point and your question as to profitability, with that type of £300-400 million change yes we do expect the Insurance business to be profitable on an IFRS 17 basis going forward. We look forward to that profitability growing on a run rate basis and we can talk more about that in terms of how we look at it and the metrics that we use and so forth if that is interesting.

Segmental restatement, Jon anything to add beyond the point that I made?

Jon Burgess
No I don't have the information to hand William, perhaps with the IR team we can work out how to address the question.

William Chalmers
Yeah. Andrew we will come back to you on that and the team at large.

Andrew Coombs
Yeah that would be helpful, it is just because the moves half on half in the Commercial bank, both NII and non-NII are sizeable. Obviously it is mainly floating rates so I would expect that, but I was just trying to get a feel for if there is anything from a change in statement effect that is distorting it or whether it is genuinely an underlying trend? Thank you.

Jon Burgess
I think there is a combination of business movements and LTP curve shifts as well, methodology type movements as well. So there is two moving parts therein which might be the source of the question, but I am sure that the IR team can help pick through that.

Andrew Coombs
Perfect, alright thank you both.

William Chalmers
Thanks Andrew.

Question 5 – Alvaro Serrano, Morgan Stanley

Hi, good afternoon William. Just further follow-up on the NIM. On your assumptions of a 4 per cent rate assumption, you have discussed the mix shift potential. You mentioned the other day in the presentation that you had already announced changes in deposit remuneration that would take effect, presumably from 1 March, and that is one of the reasons you will see margin erosion in Q2. Are you factoring any further changes in deposit yields within your plan assuming that 4 per cent. I realise rates might change and change how you might have to operate. But as a base case are you anticipating that further competition in funding could prompt you to change those remunerations, as a base case, in that 305 basis points guidance?

And the second question, we've discussed it in this call as well, but just to make sure I am not missing anything and maybe ask you for one more data point. On the mortgage book your spread was 152 basis points in the second half according to your slides which is 21 basis points lower than H1. This is a very steep reduction. Is it pretty much a fraction of this SVR book that we have discussed at length or is there something more that I am missing, because the completion margin and the Covid mortgages would have started to rollover, but only in Q4, so it seems very steep despite what we have discussed. And maybe to answer that question you can share with us, I think you used to give us, the yield on the SVR book? I don't know if maybe that is a way to answering that question if you can share that with us? Thank you.

William Chalmers
Thanks for that Alvaro. Just to take the first of those two on NIM and then come back to your SVR question. On the NIM mix shifts, a couple of points to make there. As you say we are looking at a mix shift going into the first half of this year and that is responsible for the margin development that we see. Part of that is a mix shift that is forerun by price changes that we have effectively already got in motion right now and those will be playing themselves out over the course of the first quarter. But you don't really get a full quarterly effect of those, not a run rate affect at least until you get into quarter two. And then that leads to the reduction in margin expectations that we see for the Group as a whole during the course of Q2. That then stabilises, as I said the other day, at a lower level, but at a rate still in excess of the 300 basis points before landing on the greater than 305 basis points for the year as a whole. So that pricing effect is indeed what, in part at least, develops within the margin.

There are a couple of other things that are worth highlighting though. One is that the Q4 margin benefits from effectively lag effects, from bank base rate changes which don't feed through into pricing and therefore deposit margin widening which happens during that Q4. Then because our expectation is that you don't see more base rate rises looking forward into 2023, you don't get the temporary benefit of that lag affect which you saw in Q4. So that comes out of the margin. We then see other factors start to take effect including the mortgage churn effect as mentioned just a second ago, also including some of the funding cost points that I mentioned, e.g. wholesale funding being slightly more expensive than it was before. And those start to take effect over the course of the year. So those are going on too. You asked specifically Alvaro around do we anticipate further changes in terms of deposit yields going forward over the course of this year. The short answer is yes. We do expect to see front book pricing changes over the course of this year. That is in line with some of the points I made earlier on about savings rate changes, about expected flows from PCAs into savings accounts that we anticipate. And that is led by pricing developments that we expect to play into our strategy over the course of the year and again embedded in that greater than 305 basis points guidance. So that is one. Against that, as said earlier on, the hedge is expected to be stable during this time, so if that changes, that is a new piece of information. But likewise bank base rate changes are also not expected during this time.

Your second question on the SVR. That margin 173 basis points to 152 basis points over the course of H1 to H2 Alvaro, there are a couple of points at play there. One is as you say the back book maturities, the £5 billion or so of back book maturities that took place within the SVR book are certainly a factor and bringing down that yield, 173 basis points to 152 basis points in H2. Likewise, particularly in Q4 we saw the development of the maturities of the 2020 mortgages that were written at high spreads into lower yielding spreads going forward. So that certainly had a factor in Q4. I think we have given some insight on that in the context of our margin development over the course of the year. It is augmented by the SVR book as said. Don't forget within that mix, Alvaro, that the SVR rate these days is quite high and so when you see the attrition in the SVR book, and indeed when you see part of that SVR book refinancing to lower spreads, that can have quite a significant effect when you have got an SVR that is above 5.5 per cent as it is today.

Alvaro Serrano
Thank you very much William.

William Chalmers
Thanks Alvaro

Question 6 – Chris Cant, Autonomous research
Good afternoon, thanks for taking my questions William. One on margin please and then another on your RoTE guidance. Just trying to think about the margin dynamics looking out into 2024. I appreciate there is a lot going on that you are trying to capture in the 2023 guidance but based on everything you have told us, I guess the exit run rate for 2023 should be something a little bit north of 3 per cent, but potentially below the 305 basis points. When I think about the moving parts looking into 2024 the picture is a little bit more simple. If I park rate cuts to one side for a moment, and I know you are assuming this but I am not sure if the rates market is there. You have indicated £41 billion of maturities on the hedge I think it was, that might be I guess 10-11 basis points of benefit from Q4 2023 exit rate into 2024. And then you said 8 basis points a quarter on the mortgage book, in terms of the drag, is likely to persist. So I guess the net of those two forces looking into 2024 would be something like minus 5 basis points, if I am thinking about 2024 average versus where we are exiting 2023. Is it fair to assume that the NIM might be a little bit below 3 per cent looking into 2024 even without rate cuts or am I missing something else in the mix there?

And then on the RoTE, I am just trying to understand the flat RoTE guide 2024 versus 2023. So obviously a lot of moving parts. The TNAV is expected to be higher I think in 2024 which will tend to be a headwind. Costs are guiding to be higher. Operating lease depreciation feels like it will still be normalising upwards. The effective tax rate I think is going to be a bit higher just because of the timing of the changes around the surcharge. It feels like NII is under a little bit of pressure. I know the other income line is expected to be growing given the strategic initiatives but it feels like quite a lot of headwinds for that one line to be offsetting, to keep a stable RoTE. Is there anything else you could be calling out in terms of positive supports to RoTE looking into 2024 versus 2023? Thank you.

Answer - William Chalmers
Thanks for those questions Chris, I will deal with them each in turn. First of all on the margin. As we go through the year as said we have got a Q1 that looks frankly much like Q4 really. I mean depending upon how the external environment proceeds or evolves it may be that it is a touch above, it may be that it is a touch below, but nonetheless it looks much the same. And then we get some of these full quarterly run rate factors playing out, as per I just discussed with Alvaro, that deliver a margin that goes down fairly sharply in Q2 but then stabilises in Q2 and beyond, in excess of 300 basis points. And so when you look at your picture for the exit run rate in 2023 it as said, continues to be above the 300 basis points margin. And you know, we are saying greater than 305 basis points for the guidance as a year. Within that, what might make a difference to the margin? I guess a couple of things. We have talked a lot about the base rate assumptions and of course if they are stronger than our plan that is going to exert some upward pressure in terms of the structural hedge maturities in the tail-end of this year looking forward.

We haven't then given guidance for 2024, Chris, but let me give you some thoughts on that. One is in terms of the tailwinds, as said the structural hedge maturities in the second half of this year, the £41 billion of structural hedge maturities going into 2024, that is quite a strong tailwind and it kind of accumulates as you can see through the numbers. So £75 billion of structural hedge maturities during that time. Other tailwinds that play themselves out in 2024 include other aspects of activity, other areas of our balance sheet, Chris. So unsecured volumes would be one and that is a factor that you didn't mention in your question, maybe a factor that it is worth just thinking about. How does that play into the overall margin looking forward? And then the tailwinds they are the ones that you are familiar with. I mean we talked about the mortgage margins. Those factors exhaust themselves during the course of 2024, but they still have some way to play out during that time. And then if you see bank base rate reductions as we do, that has an effect, alongside the churn and the evolution of the deposit base. And so if you don't see those rate cuts playing themselves out in quite the same way, that will have a different effect. But that gives you a sense of the tailwinds and the headwinds that we see in 2024. We haven't given guidance for 2024 explicitly as said just a second ago. And there are as you said an awful lot of moving pieces here, both internally and of course externally too, dependencies like rates, pricing activity, that are not within our control but make quite a material difference. I think in short Chris when we look at 2024, without giving guidance, we don't see an awful lot of change, not a significant change in direction that is, from what we have got in 2023.

RoTE, your second question, we have given flat RoTE guidance for 2024 over 2023, that is circa 13 per cent. You know that is basically how we see it in the context of the points that we have discussed. So if I take each of those in turn. The RoTE guidance first of all is dependent upon the macro assumptions that we have. Second, we talked about the income environment as per the comments just made around the 2024 interest income expectations. You are right, we do expect things like growth in other operating income on the one hand. Having said that, also growth in operating lease depreciation and that plays itself out over the course of the year. The costs we have given, the AQR environment we expect to be broadly similar to what we have seen during the course of 2023, as the IFRS 9 book rolls forward. There is then a third component beyond macro assumptions, beyond the returns if you like, which comes back to the TNAV situation, and as said before, we do expect TNAV to be growing in the course of 2023 and in the course of 2024 for all the reasons that we mentioned. Now could we be wrong there? Of course base rate changes may play out differently and that will then affect the TNAV growth. But some of the TNAV growth including things like the cash flow hedge reserve is dependent upon, not just base rates, but also the development of the structural hedge maturities. And so some of that cash flow hedge reserve naturally unwinds as the structural hedge unwinds alongside of it, and that is a point I should have highlighted in one of the earlier questions, just a second ago to Rohith. So that is the third factor.

I think overall Chris when we look at the RoTE guidance of 2023 and 2024 it is circa 13 per cent for both of them. As we stand here today with all of the benefit of the news flow that we have seen in the first part of 2023, it looks like 2023 is perhaps a touch more benign in the external environment. And so you know maybe an easier 13 per cent in 2023 versus 2024, but the guidance for 13 per cent for each of those two years remains very much as it is Chris.

Chris Cant
Thank you.

Question 7 – Robin Down, HSBC
Good afternoon William, thanks for taking the questions. Just a couple. Firstly around the structural hedge, you gave us the phasing in 2023, I just wonder if you could give us the phasing for the £41 billion in 2024? I know you are expecting an incremental £800 million interest income but it is kind of nice to be able to build these models up from scratch, just in case we have got different assumptions on re-investment rates to you.

And actually whilst I am on the structural hedge side, just a small request. Is there any chance we could get a bit more granularity in the numbers because I think at Q3 you said £1.9 billion and Q4 I think you were at kind of £2.6 billion for 2022. It just makes it difficult to kind of see the progression that sort of Q4 run rate if you like.

And the second question, not an area that gets a great deal of attention. I appreciate there is some crystal ball gazing here. But any thoughts on the operating lease depreciation number going forwards into 2023? We have been running for quite a while at levels that feel quite low, and I appreciate that is partly due to the used car market pricing being quite high. But I am trying to work out where the more normalised rate for that business might be going forwards? Thank you.

William Chalmers
Yeah. Thanks Robin. On the structural hedge, the phasing we haven't given for 2024. As said it is unusually unbalanced for 2023. I think all I will say Robin is that it gets back into a more normal state during the course of 2024. I won't be more precise than that because it won't be precisely even across all quarters, but it is a more balanced profile in 2024 versus what we have currently in 2023.

On the granularity Robin, but perhaps you can just give me a bit more sense as to what you meant by granularity to make sure I address the question if I can.

Robin Down
So the problem is at half year you said you had £1.2 billion of growth structural hedge income. At Q3 you said £1.9 billion. At Q4 you have got £2.6 billion. All we can see in affect is the ballpark kind of £0.7 billion for Q3 and £0.7 billion for Q4. But intuitively I would have thought Q4 would be higher than Q3 just because of the maturities and the rollovers. And I am sure we are all trying to forecast 2023 on the back of Q4 annualised. And it makes quite a big difference, if you say kind of £0.7 billion, that makes a big difference if it is £651 million versus £749 million in Q4. Some of your competitors I think give us effectively the actual current million pound number, it is just a request rather than having it rounded.

William Chalmers
Sure. Well Robin I am probably not going to give you what you want on that for now at least. It may be something that we take a look at, have a think about and come back in due course. But the best way to think about the structural hedge income going forward is, as you know we took £2.6 billion in 2022 full year. Of that about £750 million, or thereabouts, was Q4. When we look forward into 2023 we are expecting about another £800 million for the structural hedge income, so for sake of argument that is £3.4 billion. And then we expect another £800 million again in 2024, so for sake of argument that is about £4.2 billion or thereabouts. And those are the rough numbers for the structural hedge. I won't go into it on quite such a granular basis as you are requesting Robin, but we will certainly take it away and think about it.

I think one point that it is worth making though is bear in mind that these are big numbers that we are talking about. £35 billion maturities this year, £41 billion maturities next year. When we get moves in the curve of the type that we have seen just over the last two weeks for example, that has a big effect on these numbers. And you know in a sense, any precision that we can give you as to granularity is drowned out by the size of the effect from what I have just mentioned. So that hopefully goes some way, albeit I know not all the way, to answering the question you just had there Robin.

On operating lease depreciation it is a very fair question. We have as you know had operating lease depreciation driven by two things in the course of the last couple of years. In fact, going back to the pandemic really. One is slow evolution in terms of the Lex business overall and therefore relatively depressed volumes. And two is very strong used car prices. And those two in turn are partly linked obviously. Part of the reason why the Lex business is being slow is because there haven't been that many cars around. Part of the reason why used car prices are high is because there haven't been that many cars around. And so you have seen operating lease depreciation for the full year 2022 of £373 million which is an unusually low number and does not relate to what we would see as a run rate number for operating lease depreciation. Chris mentioned in his question just a second ago that that should normalise, and indeed that is the way that we see it. It is not a number that we typically guided upon but there are two factors that will lead it to normalise. One is the expected growth in the Lex fleet as indeed you know the order book right now for Lex fleet is picking up. It already was in Q4 and we expect that to play out during the course of the year. That is likely to continue going into 2024. And then secondly, partly because more new cars are coming on the market, we do expect second hand cars to come down in price a little. And that in turn is built into our expectations and that in turn will drive operating lease depreciation up.

What do we look at for a normalised number? Again we don't give guidance on this but I think you can see a drift gradually back to the types of numbers that we have seen in historical periods for operating lease depreciation. And that is likely to take place over a couple of years. So a bit during the course of 2023, a bit during the course of 2024. And then it rebuilds into a more continuous run rate after that. Final point on this, we are not worried about it from an asset quality point of view because the reserves that we have built up during this time off the back of stronger than expected used car prices give us a considerable cushion for any drop in used car prices that might happen. In fact, the cushion is above and beyond what we would have expected to have at this stage. So from a risk point of view we are, as you know, very well accommodated in terms of our expectations. All of it both in terms of the operating lease depreciation issue and the risk issue around it, are very well embedded in our RoTE assumptions.

So Robin hopefully some things to think about albeit not at the level of precision that you might like.

Robin Down
Great, thank you

William Chalmers
Thanks Robin.

Question 8 –Fahed Kunwar, Redburn
Hi William, thanks for taking my questions. Three if you wouldn't mind. Just the first one. You talked about PCAs going back into time deposits in your assumptions for 2023. Does that assumption assume we go back to the kind of pre-GFC mix that we saw when rates were this high, and if not, why?

The second question relates to that. The structural hedge you are saying is going to be flat to slightly up, deposits will be flat to slightly up as well. But within deposits you are talking about a shift from PCA to time deposits within your assumptions. I would assume that would result in the structural hedge reducing because the amount of hedgeable balances reduced as you get a shift from PCA to the time deposits?

And then the third question would be on unsecured. I mean if I look at the US, we are well above kind of pre-Covid trends in unsecured lending balances. Whereas, in the UK we are still a long way below. Is there any structural reason as to why over the next one to two years we don't go back to that pre-Covid trend line? Thank you.

William Chalmers
Yeah thanks for that Fahed. And the questions are perfectly reasonable questions. In terms of the PCA's point there are kind of three questions there but questions one and two are quite similar. So I will answer those together, and then come back to the unsecured lending balances. In terms of PCA's what do we expect to see? As said we do expect PCA's to come off during the course of this year and that is in line with our churn assumptions. PCA movements into savings. How far do we expect that evolution to go? Three points. One is the expectation that we have is that consumers, customers, do nowadays hold greater levels of precautionary balances, cash balances, than they did before. The world is a more uncertain place, nobody ever heard of a pandemic before the financial crisis, they have now. That, allied to various other things going on in the external environment, means that shocks are just more familiar, more at the front of people's minds and therefore precautionary balances are higher. Allied to that for the time being at least we are in a higher inflationary environment. And so again that will make a difference to the types of balances that people hold.

The second point is the evolution to a greater preponderance of term deposits, deposits on which interest is earned. That evolution Fahed is going to take place over a number of years. You know this is not a transition that happens overnight. This is a transition that happens over many years and indeed I suspect every bank in the world right now is thinking carefully about how that pattern evolves over the course of many years forward, not one, not two but a number.

Third, I think there is a sense in which we haven't been in a high-rate environment for the last ten to twelve years or so, since before the financial crisis. That in turn means that there is an element of unknown about the environment that we are going into. I think everybody is making their best assumptions and looking very closely at customer dynamics including us. And that data starts to emerge from the second half of last year. We are starting to see some of it now in Q4 and we will be looking at it closely. As we see it, the customer flows that we have seen so far, the plans that we have so far, enable us to be very comfortable with the assumptions that we put forward. Just as a point of detail I don't think I said the structural hedge will be flat to up. I think I said the structural hedge would be flat. And I said the deposits would be flat to up. Again it may be the deposits are flat over the course of the year and it may be they are modestly up I think I put it. I correct that just because I think it is an important distinction. Why do we feel a level of comfort around where we are? Going back actually to one of the opening questions around the structural hedge buffer. We have £25 billion of balances in the buffer on the structural hedge. That is not a run rate buffer for us, that gives us something to play with during the course of the year should trends end up being more adverse than we expect them to from the perspective of maintenance for the structural hedge. So I think Fahed on your questions number one and two as said PCAs are moving, we don't anticipate that taking place over a short period of time rather its gradual process. Structural hedge and hedgeable balances off the back of that, think about our buffer in that context, it is important.

Then go on to your unsecured question Fahed. I think the unsecured balance has been slow to evolve during the course of 2022. We do look to it to evolve slightly over the course of this year, it varies by product. We are looking at a more stable picture in terms of loans. We are looking at a little bit more growth in terms of the likes of credit cards. That is simply because of a set of behavioural assumptions and observations that we make. Having said that Fahed I think we see it as slowly returning. You know not necessarily at pace, it will play itself out over the next couple of years. Two of the distinguishing factors there, one I would highlight is in relation to us as a Group and one I would highlight is in relation to the market. In relation to us as you will have seen in our Q4 numbers we have quite a lot of people who pay off their balances. Our card base is a relatively affluent card base. That in turn means that when they go out and spend on cards, often enough they will then just pay the balance and so the interest paying balance that we will have at the end of it has been slower to recover than might be the case in other books where there is more borrowing going on. You know in that case we earn other income obviously from a transactional activity that goes on, but the interest balance is slower to recover and that is a factor for us which is characteristic of the book that we have. For the industry as a whole Fahed, the one point that I would make is that we are watching closely embedded finance, by which I mean the types of finance that are offered by merchants. We are an active participant in that through our Cardnet joint venture, through several initiatives that we are looking at as part of our strategy review. But we do expect that embedded finance industry to play a role in providing consumer credit. And likewise because of our reach with merchants amongst the SME community, because of the product capabilities that we have through Cardnet, and because of the effort we are putting in through the strategic initiatives in that respect right now, we do expect embedded finance to gradually play part of the role that in the past perhaps credit cards have done, which in turn will have an effect upon the overall growth rate within the credit card market.

Fahed Kunwar
That is super interesting. Yeah, it is just fascinating because embedded finance is actually bigger in the US and credit cards picked up even faster in the US. But I completely take your point, it is a really interesting space. And on the first question can I take it that it means then actually there is a structural difference between pre-GFC in your assumptions and what you expect to see over the next couple years?

William Chalmers
Yes I think in the next couple of years there is a structural difference Fahed. Where there is a difference in five years, ten years time, I think that is something that we are all looking at.

Fahed Kunwar
Thank you very much, that's grand. Cheers.

William Chalmers
Thanks Fahed.

Question 9 – Ed Firth, KBW
Afternoon William. Just two quick questions really. The first one was I was talking to an IFA the other day, who was saying that because of the way you do the affordability tests now, if you are looking to apply for a new mortgage you're stress tested to just short of 10 per cent. Is that right? I thought he must have got that wrong because I understand why you had to have the sort of 5 per cent buffer when rates were down at 0 per cent. But if you are still applying the same buffer once rates have gone up it seems to me there is a real danger with driving a cyclicality into the market that is possibly unnecessary. So that was my first question, just to clarify how you are doing your affordability stuff now for mortgage lenders.

The second one is, I mean it is a sort of perennial question of mine but I guess it would still be interesting to get your insight. We have still got this huge gap between what we are reading in the press about the cost of living crisis, what you are hearing from charities about the problems with people, you know the financial stress that people are under, the utility companies and everything else. And then what we are hearing from the bank sector is basically everything is fine. And I am just still struggling, it would be interesting to get your insight, do you think it could be part of the timing of the cycle? Is it that actually things are not as bad, I know the press like to accentuate these things. So maybe we are in a bit of a bluff zone. What is your sense as to how we connect those two completely disparate reads on the economy today?

William Chalmers
Yeah thanks Ed, both good questions. On the mortgage adviser question, the first one, it is interesting. I think in short the adviser may be right for some institutions but I suspect on the whole Ed, he or she is probably wrong. In the sense that I think most institutions are starting to develop their stress tests in the context of what they see as the outlook going forward. So we have a number of affordability tests for our mortgages. We have always typically applied one in the past which is SVR plus 3 per cent. Having said that, that SVR plus 3 per cent depends in part upon the rate outlook that we see. So there is no point in testing SVR plus 3 per cent when you are looking at a rate outlook that is going down rather than up. And so we typically adjusted the 3 per cent over the course of the rate cycle depending on where we see rates go and indeed that remains the case today, Ed. SVR in the course of the first quarter will actually go above 6 per cent off the back of the base rate changes that we have seen. But SVR is kind of there or thereabouts and therefore plus 3 per cent is taking it up into that 9-10 per cent territory that you mentioned. We are adapting that plus 3 per cent stress in the context of the rate environment that we see so that it doesn't get quite that high and so that we remain competitive. And I suppose Ed by definition therefore the need to remain competitive gives you an idea as to what the others are doing, something very similar to us I suspect.

Ed Firth
Do you get flexibility on that, how much of that is defined by the Bank of England?

William Chalmers
Well, there are regulatory thresholds but they don't require SVR plus 3 per cent in short Ed.

Ed Firth
Okay great.

William Chalmers
Having said that there are a number of affordability tests that we apply to the mortgage book. So for example we have loan to income thresholds. We obviously have loan to value caps. We have haircuts against variable forms of income including bonus compensation and the like. And so while the SVR plus 3 per cent is the traditional test that we have applied and actually did apply until very recently i.e. a quarter or so ago. We have now softened our SVR plus 3 per cent but the LTI caps, the LTV caps, the bonus haircuts, all of these types of variables still apply and the end result of it all is that it ends up being a high quality mortgage book, Ed as you know; loan to value very low, average customer incomes £75,000 and so forth. That is a result of a number of affordability checks that we implement not just the SVR plus, one.

The second question Ed in terms of stress, it is interesting, I mean I think your characterisation of it is about right. That is to say you do see some fairly dramatic press headlines that are not necessarily matched by what we, and I suspect others, see in terms of the performance of their books. So if I talk you through what we have a number of early warning indicators that give us insights as to what is developing within the book. So if I give you some thoughts on that in each of Retail, Commercial Banking and Insurance. Within Retail we have seen cancellations of subscriptions basically flat over the course of the last quarter. We have seen savings top ups decline slightly but not by a great deal. We have seen refused payment notifications broadly stable. We have seen credit card minimum payers slightly up on the month, in January that is, but that is seasonal, it always goes up a little bit in January, and actually if you look at the levels they are pretty much in line with what we have seen over the course of the year. Likewise unarranged overdraft users down during the course of January. New to arrears we saw a modest increase in unsecured but no increase in secured during the month of January. So again these early warning indicators within Retail pretty benign. Commercial banking, very similar, SME term loan customers in arrears stable. Trade limit utilisation, a modest increase but not by much. SME liquidity levels, a modest decline but still very reasonable levels. And then in Insurance, nobody is yet cancelling insurance policies or not very many. You have seen our persistency assumptions actually improve in Q4.

It is not that there is nothing going on. You can certainly find you know the odd piece here or there that will show you a sub section of customers having a slightly tougher time, but they are very modest levels compared with what one would expect to see in a real downturn or in a real recession of any type. And indeed modest levels even compared to our base rate assumptions that we have. And so that gives you the story from the banks perspective on the early warning indicators there. And I think then there are examples of where some people in society are seeing jumps in payments off the back of higher rates. Some people in society are seeing tougher situations undoubtedly. But I suspect partly because of the selection that we have in our book by virtue of the underwriting standards across the book, not just secured but also unsecured, we are seeing less of that in terms of the performance of the book. The unsecured book is prime, the mortgage book we just talked about. We don't really see so much of this going on within the customer base. Not to say that we won't see any of it, that is why we have provisioned off the back of our IFRS 9 provisioning in the course of 2022. But we will see proportionately less of it I suspect because of the selection within the customer base through underwriting policies. And at the moment at least the early warning indicators have been very solid.

There is one other point I would make on that Ed before wrapping up on this topic is if you look at our impairment charge for Q4 we had an impairment charge of £465 million for Q4. That includes an observed charge, actual defaults as opposed to multiple economic scenarios, of £383 million. If you strip out a single-name charge in the Commercial book we talked about last Wednesday, that is about £85 million or so. So that takes an observed charge down from £383 million to closer to £300 million. You can then strip out a component of that £300 million that is underlying model calibrations. So things like the roll forward of stage one book for example, with one or two other bits and pieces going on as well. But one would wish to strip that out in order to get to the core of actual default experience within the observed charge. And if you do all of that you can see the observed charge after making those adjustments is ever so slightly up on Q1, Q2 and Q3. But it is really very modest and to put that in basis points you are looking at somewhere between 17 to 20 basis points for Q1 and Q2. Probably around 20 basis points for Q3 and then probably around 22 to 23 basis points for Q4 after making the adjustments that I have just mentioned. So there is not a lot going on Ed in short.

Ed Firth
Is there a concern though that perhaps if that is the case, and I suspect it has been driven more by the regulator than the banks, that actually the sector has been too conservative for the last five or ten years. Then actually you have effectively been lending on a no loss basis rather than on a reasonable loss basis?

William Chalmers
Well maybe I will answer your question this time next year Ed.

Ed Firth
Okay that is fair. Thanks very much.

William Chalmers
I think we feel very comfortable with the provisioning that we have taken, Ed, to your point. Hopefully the insight of the numbers that I just gave you give you a sense as to what we are taking on charges on an assumption basis versus what we are actually seeing. You know let's see how this year and next year plays out. But as said we feel very comfortable with the provisioning position in the book.

Ed Firth
Perfect, thanks.

William Chalmers
Thanks Ed.

Operator I was going to say that we are a little over the end of the call. So operator, unless there are any other questions we might just call it a day, and say thanks to everybody for joining.

Operator
We have no further questions at this time.

William Chalmers
Okay, great. Well again thank you to everybody for taking the time. Look forward to staying in touch and again appreciate your time and investment in the story. Thanks guys.

Operator
This now concludes our call. Thank you for attending. Participants you may disconnect your lines.

END

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