LLOYDS BANKING GROUP PLC – 2022 HALF YEAR RESULTS PRESENTATION TRANSCRIPT
(amended in places to improve readability only)

Wednesday 27 July 2022 – 9.30am

LBG:
Charlie Nunn, Group Chief Executive
William Chalmers, Chief Financial Officer

Charlie Nunn
Good morning, everybody and thank you for joining our half year results call.

As you know, our purpose as an organisation is to help Britain prosper and despite the uncertain external environment, we see significant resilience within our customer franchise and our financial strength positions us well to continue to focus on this as we go forward. I will talk about this more shortly. But let me begin by turning to slide 3. I am going to take you through the key messages from the half and then William will give the usual review of the Group's financial performance before we open up for Q&A.

There are five key messages that I would like you to take away from today.

First, in the context of a cost of living stress, we are seeing our customers adapting their spending, where needed, and taking the decisions required to maintain their financial resilience.

We have delivered a strong financial performance in the first half of 2022, based on improved income, increased investment and benign asset quality, alongside continued business momentum.

Our financial performance in H1 has enabled us to enhance guidance for 2022. William will go through this in more detail later, although I should note that, as usual, we are not going to give updated guidance for 2023 or 2024 at the half year. We are confident in the future and executing well, but it is simply too early to update longer-term numbers.

The financial performance has also enabled the Board to announce an interim ordinary dividend of 0.8 pence per share, up around 20 per cent on last year.

And finally, our strategic delivery and conservative-risk business model, position the Group well for the future.

So with that, I will now turn to slide 4 to look at how we are well positioned to navigate the external uncertainties. It is clear that our customers are facing a challenging period with increases in the cost of living. However given the nature of our customer base, the positioning of our balance sheet and our conservative risk appetite, we see a resilient franchise today and looking forward.

We are not currently seeing signs of stress in the portfolio and our business is well placed. In Retail, we have a representative sample of deposit customers from across society, while our lending exposure is focused on higher income segments. We know that inflation is significantly more impacting for low income customers and they have lower levels of borrowing from us.

We also see the majority of our lending within secured business lines, with average loan to value ratios at historic lows, around 40 per cent in both our Retail and Commercial businesses. At the same time, our unsecured businesses are focused on prime customers and we are not seeing any deterioration in their trends.

It is also worth noting that, on average, customers are entering this period in better financial health than pre-pandemic, having increased their savings pots and reduced their debt.

In terms of customer behaviour, we are seeing increased levels of spend, most notably in higher income segments and within discretionary categories such as travel and entertainment.

Customers are also adapting their finances to accommodate the rising cost of living. For example, we can see customers spending less on white goods and taking actions such as managing subscription services to accommodate the increased costs of energy, food and fuel. On the other hand, we see no increase in our customers cancelling insurance policies or opting-out of auto-enrolment pensions.

With that said, we remain very focused on supporting our customers where needed. We are fully resourced for this additional demand, although as mentioned, the vast majority of customers are continuing to demonstrate resilience.

We have also taken early action to announce a one-off payment to all members of staff below the executive team. This was the right thing to do. By taking action quickly and not spreading the payment, we will give our colleagues a cash injection which will help ease the pressure they face.

Now turning to slide 5, to look at an overview of the business and financial performance in the half. Lloyds Banking Group delivered a strong performance in the first half and our business model positions the Group well for the future. Net income of £8.5 billion is up 12 per cent year on year, supported by a higher net interest margin. BAU costs were stable while operating costs are up 5 per cent, driven by our increased strategic investment and new business lines.

Asset quality remains benign, given the resilient customer base I have just touched upon. In turn, these support a return on tangible equity of 13.2 per cent, capital generation of 139 basis points and the increased interim dividend. This performance also enables us to enhance our guidance for 2022.

Alongside our financial performance, we have seen some important business achievements in the half, including maintaining a leading net promoter score of +68. Employee engagement of 72 per cent has held stable since the end of last year while we are also continuing to make progress on our diversity goals, including now having 39 per cent of senior roles held by women. There is always more to do, but this represents good progress.

Finally turning to slide 6. It is five months since William and I set out the Group’s new strategy and you will recall that we talked about three key pillars: Grow, Focus and Change. We are making good progress and we have set out a few examples of our early achievements on this slide.

Within our ambitions to grow the business, we have seen over £4 billion net new money within Insurance and Wealth and a 1.5 percentage point increase in protection market share. In Commercial, we have increased our percentage share of FX wallet by 20 per cent and delivered a 10 per cent increase in new merchant services clients.

Our green lending ambitions are also on track. We have provided around £4 billion of sustainable financing in our Commercial businesses. And in Retail, we are on-track with our Green mortgage lending and have increased our funding for electric vehicles by over £0.9 billion in the first half. Our strategy also targeted strengthened cost and capital efficiency under our Focus pillar. We have continued to generate significant BAU cost savings and you will hear more about this from William in due course.

Finally, under Change, we have announced a new organisation structure and leadership team, aligned with our plans for delivery of the Group’s clear strategic objectives. We have also reorganised around 20,000 colleagues, which will enable us to deliver change and innovate our digital and technology assets faster and more effectively.

And we have mobilised the skills and capabilities to deliver the incremental investments for our new strategy and have made £0.3 billion of strategic investment to date. These are selected examples of the progress we have made and we will provide a more detailed update to the market in the first half of 2023.

So in summary, I am pleased with the progress we have made and I am confident we are well positioned for the future.

With that, I will hand over to William to go through the financials in more detail.

William Chalmers

Thank you, Charlie. Good morning everyone and again, thank you for joining. Let me turn first to an overview of the financials on slide 8. As Charlie said, Lloyds Banking Group delivered a strong financial performance and continued business momentum in the first half of this year.

Net income of £8.5 billion is up 12 per cent on prior year, supported by a higher net interest margin of 277 basis points and growth in other income. We remain committed to our market-leading efficiency. Operating costs of £4.2 billion are up 5 per cent, based on stable BAU costs, before higher planned strategic investment and the costs associated with new businesses.

Asset quality is in very good shape. The impairment charge of £377 million, equivalent to 17 basis points, is below pre-pandemic levels. Together, this strong performance resulted in statutory profit after tax of £2.8 billion and a return on tangible equity of 13.2 per cent. Alongside, we have continued to see balance sheet growth across our franchise areas.

Meanwhile, tangible net assets per share of 54.8 pence are down 2.7 pence in the half, largely as a result of the upward movement in rates. I will touch on this further towards the end of my comments. A good earnings performance, bolstered by a reduction in risk weighted assets and insurance dividends, has delivered capital generation of 139 basis points. This in turn allows the increased interim dividend that Charlie talked about earlier on.

I will now turn to slide 9, to look at the continued recovery in customer activity and franchise growth seen in H1. Our mortgage portfolio has continued to grow, with balances up £2.2 billion in H1. Growth in the open book of £3.3 billion, included £1.6 billion in the second quarter, demonstrating continued progress throughout the half.

Encouragingly, we saw growth of £400 million in the credit card book, all in the second quarter, as a result of improving spending levels, particularly in travel, entertainment and retail. Led by transactors, this Q2 spend was 17 per cent over the equivalent period in 2019. Looking forward we expect the gradual growth in cards balances to continue in the coming quarters. Motor Finance is also up £200 million in the half. While we have a record order book, activity here remains impacted by the ongoing global supply chain issues affecting vehicle manufacturers.

As you can see, Commercial Banking balances are up £4.3 billion in the half. This is led by attractive Sponsor opportunities within the Corporate and Institutional franchise, some short-term refinancing business and also by FX revaluations in the portfolio, particularly in Q2. This growth has more than offset repayments of Government support scheme loans in SME.

On the other side of the balance sheet, we continue to see inflows to our trusted brands. Retail deposits are up £3.3 billion in the half, with growth in both quarters. Commercial has seen some short-term placements reversing as we expected in Q2. And in total, Group deposits are up £2 billion in H1, having grown almost £70 billion since the end of 2019.

As you know, the substantial deposit growth offers the Group strategic opportunities to build our franchise, while increasing our pool of hedgeable balances. I will touch on this again shortly.

Alongside our banking business, we have seen good organic growth within Insurance and Wealth, across business lines and including over £4 billion of net new money in the first half.

I will now turn to slide 10 and the improving net interest income performance in a little more detail. NII of £6.1 billion is up 13 per cent versus the first half of 2021 and up 7 per cent on the second half of that year. This has benefitted from both a modest increase in average interest-earning assets and a higher net interest margin.

AIEAs of £450 billion are up £1.3 billion in the half, with mortgage growth more than offsetting the timing-related reductions within Commercial Banking. Our H1 margin of 277 basis points increased 21 basis points on H2‘21. The Q2 margin of 287 was up 19 basis points on the previous quarter. The positive impact from rate rises here has more than offset the ongoing impact of competitive mortgage pricing.

Looking forward, we continue to expect low single digit percentage growth in AIEAs in 2022. This will be driven by continued growth in mortgages and the gradual recovery in unsecured balances. We are now assuming that the base rate increases to 2 per cent in Q4, providing a further tailwind this year. In the other direction, we expect the impact of mortgage repricing will continue to be felt within the Group margin. But taken together, this remains a significant net positive and hence we expect margins to be sustainably higher than assumed in February. Indeed today we are enhancing our margin guidance to greater than 280 basis points for 2022.

Given the significant focus on interest rate sensitivities, let me turn to slide 11 and look at this in a little more detail. As you have heard us say many times, the Group is positively exposed to rising rates.

We currently expect a 25 basis point parallel shift in the yield curve, and associated base rate rise, to benefit interest income by about £175 million in year 1. As you know, this number is illustrative and based on the same assumptions, including a 50 per cent deposit pass through, as those we set out previously. Clearly, the pass through could differ from our 50 per cent illustration, as indeed we saw through the first half. That in turn makes a material difference to income.

Taking the 25 basis point increase as an example, for every 10 percentage point reduction in the assumed pass through, we expect an additional £50 million of net interest income in year 1. So, if you assume a 40 per cent pass through, the sensitivity would be £225 million. I should also note that the sensitivity does not assume asset spread compression, as we have seen in the first half, most evidently in mortgage new business margins.

Now moving on to look at the individual asset portfolios, starting with mortgages on slide 12. We continued to see mortgage growth in H1. The open book now stands at £297 billion with growth of £3.3 billion in the half and £1.6 billion in Q2.

The SVR book of around £57 billion is down 20 per cent over the last twelve months. Q2 attrition levels were modestly higher than we have seen in previous quarters. Indeed in the context of a rising interest rate environment, customers have re-fixed their mortgages. And we in turn are actively engaging with our customers to ensure they are aware of their alternatives and to help with any consequent steps. As you know, mortgage pricing has been competitive over recent quarters. Q2 completion margins were around 60 basis points. But now helpfully, the completion-application margin dynamic is stabilising as customer pricing has increased in response to swap moves.

Looking forward, we expect new business to continue to be priced below higher-yielding maturities in the context of our circa £90 billion of gross lending per year. With that said, at current margins, we still see mortgages as attractive from a returns and economic value perspective.

Now turning to our other asset books, on slide 13. Consumer finance balances have increased £1 billion since year end. We are seeing a recovery in credit card spend, particularly in discretionary categories. This has translated into £400 million higher credit card balances, largely in the second quarter.

As mentioned, motor finance is up £200 million, although this continues to be impacted by the wider motor industry issues. Commercial Banking is up £4 billion in the half, as I said earlier. Indeed, the underlying Commercial business has grown by £5.4 billion in H1. This is led by attractive growth opportunities particularly in the Corporate and Institutional business, as well as FX revaluations in the portfolio. Going the other way, we have seen a reduction of £1.1 billion in Government-backed support scheme lending, largely within SME, as clients repay their COVID loans.

Let’s move to the other side of the balance sheet on slide 14. We continued to see deposits increase in the first half of 2022. Total deposits are up £2 billion in the half, although they reduced in Q2 as some short-term commercial placements reversed, as we had expected. Importantly, we continue to see inflows to our trusted brands. Retail current account balances were up £1.9 billion, or 2 per cent, in the half and £0.3 billion in Q2.

Total Group deposits are now almost £70 billion higher than at the end of 2019. This in turn gives the Group strategic opportunities to further support customers as we seek to develop our Wealth proposition for example.

The overall H1 deposit margin of 41 basis points is significantly higher than last year, given interest rate movements. Deposit growth also increases hedgeable balances. This is outlined on slide 15. Given the deposit growth of the last two years and the increased eligibility of existing deposits, structural hedge capacity has increased in recent periods, including by £10 billion in H1, to £250 billion.

In the context of the favourable swap curve movements seen this year, the nominal balance of the structural hedge is now fully invested up to this approved capacity. The weighted average duration of the hedge is now around three-and-a-half years, a little below the neutral position of around 4 years. We still have £13 billion of maturities in H2 and £35 billion in 2023, giving us significant flexibility.

Given these developments, we have seen gross hedge income of £1.2 billion during the first half. Looking forward, we now expect structural hedge income to be stronger in 2022 than in ‘21 and then continuing to build into ‘23 and ‘24.

Now moving to other income on slide 16. Other income at £2.5 billion is up 5 per cent on the prior year. We continue to see signs of recovering customer activity. Indeed, Retail has seen an improving performance in current accounts and credit cards, founded upon this increased activity.

Other income in Commercial was supported by improving transaction banking volumes and a resilient Financial Markets performance over the period as a whole. Insurance and Wealth now includes a modest contribution from Embark and some assumption benefits. However, year on year growth is largely driven by improved new business income, for example in workplace pensions and bulk annuities, especially in Q2.

The second quarter performance of £1.3 billion is in line with the last few quarters. The quarter is relatively straightforward, with one-off charges, including within Equity Investments, offset by insurance assumptions and asset sale benefits.

Looking forward, we continue to expect the other income run rate to gradually build. This will clearly be dependent on customer activity levels in an uncertain macro, as well as our ongoing strategic investments.

As a temporary constraint on that pattern and as mentioned previously, remember that we will see the impact of IFRS 17 in Q1'23. We will talk more about this in future presentations.

Moving on, the Group has maintained its focus on efficiency during 2022. Let me talk more about this on slide 17. Operating costs of £4.2 billion are up 5 per cent on prior year. As we guided to, this includes broadly stable BAU costs, combined with higher planned investment and the costs associated with our new businesses.

Our Q2 cost:income ratio of 50.2 per cent remains market-leading. And as you can see on the slide, the cost:income ratio excluding Remediation is 49.6 per cent, which is slightly better than previous quarters. We are obviously not immune from inflationary pressures, but we maintain our rigorous approach to cost management. We strive to offset inflation, including absorbing additional colleague compensation of £65 million in Q3, in respect of the one-off payment to staff. As a result, we continue to expect 2022 operating expenses to be circa £8.8 billion.

Finally on Remediation, the charge of £79 million in H1 reflects a number of pre-existing programmes. There is no charge in the half in respect of HBOS Reading, albeit the final outcome remains uncertain. Going forward, we continue to expect an ongoing Remediation cost of £200 to £300 million per year.

Looking now at impairment on slide 18. The impairment story is benign. The net impairment charge of £377 million in H1 equates to an asset quality ratio of 17 basis points.

Behind that number, asset quality remains strong and new to arrears remain low, with underlying charges below pre-pandemic levels. The underlying charge of £282 million includes charges of £315 million in Retail and a release of £37 million in Commercial. We then have a charge of £95 million in respect of our updated economic scenarios. Our new base case economic assumptions include a slightly weaker GDP and unemployment forecast, alongside higher inflation.

As part of the impact of economic assumptions, we have increased cost of living and other inflationary charges in Retail and Commercial in the half by £400 million. This includes both modelled impacts and judgements, and is on top of the £60 million that we took at the end of last year.

Against this, we released £300 million of the net COVID-related judgemental overlays in the second quarter, reflecting the reduced risks in this area. This includes £200 million of the £400 million central overlay.

We therefore retain about £500 million of COVID-related provisions within our ECL, both centrally and within the portfolios. As a result of H1 performance and economic assumptions, our stock of ECLs remains stable at £4.5 billion, around £0.3 billion higher than at the end of 2019.

In summary, we remain vigilant for any impacts from rising inflation, but the Group is performing well and remains well positioned. As a result, we now expect the net asset quality ratio to be less than 20 basis points for 2022.

Moving on, I will turn to slide 19 and look at the resilience of our Retail portfolio. As Charlie said earlier, we are very aware of the potential impact on our customers of higher inflation. However, as also outlined, our low-risk approach means we have limited exposure to those segments most at risk. We are indeed proactively seeking to support customers where required, but we are not seeing meaningful signs of distress.

As you can see on the chart, our Retail businesses are seeing stable and benign arrears performance. Credit card expenditure is picking up, but it is led by discretionary sectors such as travel and entertainment. Around 90 per cent of credit card spend is now from customers in middle and high income segments, up from around 80 per cent in 2019. Furthermore, we are seeing the proportion of regular minimum payers hold very stable, it is another sign that our customers are spending within their means.

As you know, our largest asset exposure is to mortgages which is a high quality, low risk portfolio. Our book stands at £310 billion and has an average loan to value ratio of 40.2 per cent. We now have just 3 per cent of mortgage balances on an LTV of greater than 80 per cent and 0.4 per cent of balances with an LTV of greater than 90 per cent. The significant de-risking undertaken in recent years, alongside favourable house price movements, means that our customers have a lot of equity in their homes.

Let me turn now to slide 20 and consider how our Commercial portfolio is performing in the current environment. Within Commercial, we are seeing stable SME overdraft and corporate revolving credit facility utilisation trends, with RCF drawings at around 50 per cent of 2020 peak levels. We also see low and stable levels of transfers onto watch lists or into our business support unit, again below pre-pandemic levels.

Across Commercial, we have strict sector caps and have undertaken recent stringent reviews of all portfolios, given the macro outlook. Indeed our current impairment judgements are based on this work. In Commercial Real Estate, our exposure has been significantly de-risked in recent years. Net exposure is £11.1 billion, after taking into account risk transfer transactions. The business has an average LTV of 39 per cent while just 12 per cent of clients have an LTV of greater than 60 per cent. Average interest cover is greater than 4.5x. Of course we remain vigilant for signs of stress across our lending portfolios. Currently customers are performing strongly, making discretionary choices, with very high levels of security.

Moving on, let me turn to slide 21 to look briefly at the below the line items. Following the reporting changes implemented at the year end and as intended, underlying and statutory profit are converging. The limited costs booked below the line include restructuring costs comprising M&A and integration. The half year charge of £47 million includes the early integration costs relating to the acquisition of Embark.

Volatility in H1 includes favourable banking volatility given recent rate and FX movements, partly offset by negative insurance volatility driven by rates. It also includes the usual fair value unwind and amortisation of purchased intangibles. Given the prior year comparative includes significant impairment and tax credits, current period statutory PBT of £3.7 billion and PAT of 8 billion both represent strong financial performance. The resulting return on tangible equity for H1 is 13.2 per cent, well above our cost of capital.

Given the improved income and impairment outlook, we now expect the RoTE for 2022 to be circa 13 per cent. It is worth noting that this includes a benefit of just under 1 percentage point from movements in the cashflow hedge reserve, which we do not expect to recur in future years.

A quick word on tangible net assets. TNAV per share of 54.8 pence was down 2.7 pence in the half. The contribution from attributable profit was strong, but this was outweighed by movements in the cashflow hedge reserve and distributions. As you know, the cashflow hedge reserve movement is linked to interest rate movements and has no effect on capital.

Now turning to slide 22 and looking at risk-weighted asset and capital developments during the first half of the year. Capital generation in H1 is strong.

RWAs of £210 billion are down £2 billion, excluding the regulatory inflation of £16 billion on the 1st of January that we set out previously. Underlying lending growth has been more than offset by model reductions and ongoing portfolio optimisation. We have seen no increase in RWAs from credit migration.

Looking forward, we continue to expect 2022 closing RWAs to be around £210 billion, given expected balance sheet growth, broadly offset by continued optimisation. Looking at capital generation, the healthy banking profitability in the half is bolstered by lower RWAs. This was further supplemented by £300 million in dividends from the insurance business, benefitting from interest rate rises. In total, the 139 basis points of capital generation was, as said, a strong performance.

As mentioned last quarter, our capital generation has enabled the Group to make significant accelerated pension contributions. The full fixed pension contribution of £800 million for 2022 is complete. There will now be the remaining variable contribution to make in the second half of the year.

The strength of the Group's performance and prospects enables the Board to announce an interim dividend of 0.8 pence per share, up around 20 per cent on last year. As always, we remain committed to excess capital returns and will consider further distributions at the year end, as appropriate. Looking forward and based on the performance to date, our business model and macroeconomic outlook, we now expect capital generation for 2022 as a whole to be in excess of 200 basis points.

And finally turning to slide 23. In summary, the Group has delivered strong performance in H1, with net income up 12 per cent supported by the net interest margin of 277 basis points.

Asset quality remains in very good shape. The AQR of 17 basis points reflects sustained low levels of new to arrears and resilience looking forward. The return on tangible equity of 13.2 per cent reflects our healthy profitability. And capital build of 139 basis points in the first half is a strong outcome. And together, these factors enable a significantly increased interim dividend of 0.8 pence per share, in line with our progressive and sustainable dividend policy.

As you know, uncertainties persist, particularly relating to the increased cost of living and the impact this could have on customers. However the Group faces the future with confidence. This is reflected in our enhanced guidance for 2022. We now expect the net interest margin to be in excess of 280 basis points, the asset quality ratio to be less than 20 basis points, the return on tangible equity to be circa 13 per cent, and capital generation to be more than 200 basis points.

That wraps up my comments for this morning. Thank you for listening. Let me now hand back to Charlie for his closing remarks.

Charlie Nunn
Thanks, William.

So as I said up front, there are five key messages that I want you to take away today. First, in line with our clear purpose of helping Britain prosper, we are focused on proactively supporting our customers and colleagues with the increased cost of living. However the vast majority of our customers are adapting to the changing economic environment and are demonstrating financial resilience.

We have delivered a strong financial performance in the half, with improved income, increased investment and benign asset quality. This is based upon continued business momentum and franchise growth. Whilst there are clearly uncertainties in the operating environment, we are confident in the future and have enhanced our guidance for 2022, as you have just heard from William. Our financial performance has enabled the Board to declare an increased interim dividend. And finally, our financial performance, alongside our resilient portfolios and early signs of strategic delivery position the Group well for the future.

That concludes our presentation for this morning. Thank you for listening. I will now hand back to our operator for the Q&A.

Question and Answer Session

Question 1 – Joe Dickerson, Jefferies
Good morning, thank you for taking my question and congratulations on a very strong set of numbers. Two things from my side. You provided some interest rate sensitivity with a 50 per cent pass-through and then some sensitivities around that. Could you just explain for us what that was in the first half of the year, or say in Q2, just to gauge where we have been on a slightly backward-looking view?

And then secondly, with the card commentary that you have mentioned, it seems like there could be some meaningful impact on the Group's margin in terms of favourable mix on the Retail side. How was that factored into this year's NIM guidance if at all? Thanks.

William Chalmers
Thank you Joe, I will perhaps take both of those. The first question in relation to pass-on. As you say, we have provided some added sensitivity today to accompany our usual sensitivities there. The pass-on assumption in the base case sensitivities as you are aware is 50 per cent. We use that as an illustrative number to give you some idea of the effect of a parallel shift in market and base rates. We have typically operated at levels below that during the first half but we don't typically disclose exactly what our pass-on is in any given half or quarter. And again, I don't think we will break that pattern today, but you can see that effectively a reduction in pass-on makes a material difference to both net interest income and indeed to NIM. The illustration that we have given there is a 10 per cent reduction in pass-on to 40 per cent rather than 50 per cent makes a difference of £50 million, which, by way of interest margin is around one basis point or there about. So it gives you some idea of calibration. While we don't disclose specifics, it is generally the case that the pass-on that we have in practice seen in the first half has been somewhat less than the 50 per cent illustration that is in those slides. That is really determined by two or three factors.

One is competitive conditions that we see in the market. Two is the overall funding position of the balance sheet. As you are aware, we are operating at a loans deposit ratio of around 95 per cent. And three, and most importantly for our franchise, is making sure that we offer customers a great service and great value. So we seek to satisfy those three constraints. As said, in the first half we typically have been operating at levels below 50 per cent in the illustration. I suspect that as rates rise we will see that gradually gravitate back towards levels that we use in our planning assumptions, which by the way, are slightly ahead actually, i.e. above the 50 per cent illustration that you see in the slides. So that is the first question.

In terms of the impact of cards, the impact on mix in margin. A couple of points that I would make. You have seen our Q2 margin is at 287 basis points, which is an improvement of 19 basis points over Q1 at 268 basis points. We have seen a variety of headwinds and tailwinds in that composition. We have seen the benefits of the Bank Base Rate moves, aligned with investing the hedge at higher interest rates, and then some funding and capital support. That is slightly offset by mortgage headwinds, as high yielding maturities start to mature into slightly lower yielding front book margins. As we look forward, those dynamics are going to shift a little bit in the sense that we will continue to see support from Bank Base Rate changes, likewise deployment of the hedge in a favourable interest rate environment. The mortgage headwind will strengthen a little bit.

You asked specifically about cards. There is no doubt that an expansion of cards is likely to be beneficial to our Group margin. To be clear, the expansion we have seen so far has been transactor led and slightly less about interest bearing balances, And so the beneficial effect of that to date has been relatively modest. But clearly, if we see these patterns continue, increased travel expenditure for example over the course of summer, increased restaurant and entertainment spending that we have seen. If those patterns continue and lead to increased interest bearing balances within the cards book, that will indeed accrue a favourable mix development within the business. We have to see obviously in the context of the macro how that evolves, but as I mentioned in my comments, we expect to see gradual improvement, i.e. increases in cards balances for the remainder of this year.

Joe Dickerson
Great that is helpful, many thanks. Just to interpret the answer on the second question. Basically if card loan does pick up to a material extent it is, for the lack of a better word, all else equal, optionality on top of what you have already provided in terms of the guide.

William Chalmers
We have assumed a level of gradual increase in unsecured balances generally, in our business planning assumptions. That in turn lends support to our guidance of greater than 280 basis points margin for the year. So there is some element of increase in balances assumed there, albeit depending on when it takes place it will have more or less effect on the Group margin. Overall that is the expectation, if it exceeds those expectations then yes it has a beneficial margin effect above and beyond.

Joe Dickerson
Fantastic. Thank you very much.

William Chalmers
Thank you Joe.

Question 2 – Omar Keenan, Credit Suisse
Good morning everybody. Thank you for taking the questions. I have got two questions please, one on the RoTE target and one on NIM. So firstly on RoTE. I appreciate you said it is too early to update the 2024 target, but at a high level, since the strategy day the near term NIM guide has gone from above 260 basis points to above 280 basis points, assuming base rates now stay around 2 per cent. And quite simplistically, if you add 20 basis points of NIM to the 2024 target then the 10 per cent becomes 12 per cent and presumably the strategic initiatives are still supposed to deliver another incremental 2 per cent by 2026. So is it broadly correct that if higher rates are sustained, then the current 10 per cent in 2024 and 12 per cent in 2026 will be 12 per cent and 14 per cent? And, in terms of waiting for the full year results, is it really the sustainability of the rate picture that you are looking for?

And my second question on NIM. If we think about the 287 basis points that was delivered in the quarter, funding and capital delivered 4 basis points that was strong, and presumably deposit pass-through was a lot better. And we are not seeing deposit mix shift yet. I appreciate you don't like to give forward guidance, but with the Bank of England going to hike presumably next week 25 basis points or 50 basis points, can you give us a bit of an indication as to what the three variables on deposit pricing you have talked about are currently looking like? Is it still broadly favourable and what level of interest rate do you think will start to see a bit of a mix shift from current savings accounts? Thank you.

William Chalmers
Thank you Omar. There are two questions there, one on RoTE and one on NIM. First of all, I will comment on the RoTE question. In essence when we set out the February 24th presentation, our expectations, we put forward a 2024 RoTE of greater than 10 per cent. There have been significant developments across the market since then, including significant rises in market interest rates. Also significant increases in base rate expectations. And those have played through in the business over the course of H1 and we expect them to continue to play through over the course of H2 and indeed beyond. So many of those trends that we have seen in terms of market rates and Bank Base Rate changes lead to sustained improvements in the context of net interest income, in the context of net interest margin, both this year and beyond. When we look at other aspects of the business, indeed there are also some beneficial impacts that we are seeing. Operating lease depreciation for example continues to stay low and the impairment performance is pretty much mapping out as planned, albeit as said today we continue to see very benign impairment experience.

Now having said all of that, we see an overall stronger picture than February 24th, but we are not inclined to update our plan on a six monthly or quarterly basis. So we will take a look at that in the context of the full year results that we announce next year. Safe to say, that the way in which the market is panning out and our income development is corresponding to that, it is materially stronger now than it was as at February 24th when we set our assumptions out.

On the NIM, a couple of points really. What have we seen on NIM in terms of the development? The H1 development, as I mentioned earlier on, has seen some benefits from Bank Base Rate changes and deployment of the hedge. And some headwinds from mortgages. As we look forward, we see those tailwinds from Bank Base Rates and hedge continuing to be favourable and continuing to play their way out into the margin. And the headwinds from mortgages we see as gradually intensifying, as the high yielding book redeploys into slightly lower yielding front book margins. So what does all of that mean? Two or three points. One is Q2 has been 287 basis points. Our summary of look forward expectations is therefore that H2 margin, given our guidance of greater than 280 basis points for the year, is by definition going to be higher than our H1 margin of 277 basis points. The extent to which it is higher is going to depend in part upon pass-on assumptions in terms of the Bank Base Rate moves that we expect to see and to a degree at least activity dependent. But if you sum it all up, from Q2 we are looking at a broadly flat margin as we look into the remainder of this year, which again coming back to your first question is a significant improvement on where we were versus the 24th of February.

In terms of the overall impact of that on deposits, that you highlighted in your question there, we have seen continued deposit inflows during the course of the first half, including into PCA accounts. It maybe that over time that balance tilts into savings and indeed we expect to see savings growth in the course of H2. So that is the expected pattern for sure, but again we have seen continued inflows into the current accounts mix that we have seen in the first half of this year. We expect some element of that to continue, albeit as you say perhaps with more of a savings twist.

Charlie Nunn
William I will just add one thing if that is alright. Omar it may or may not help, you can tell us. The guidance we gave around 50 per cent pass-through on the base rate, we always said was a through-the-cycle view around this. Obviously the competitive context has been different from that in the first half. But I do think as you head towards 2 per cent interest rates based on previous cycles, that is the level at which the 50 per cent pass-through becomes the more normal standard. Now we will need to see what happens this time and obviously there is some dynamics in the UK between pricing on assets and liabilities that you are all tracking carefully. But I think, as you said, the next 25-75 basis points you would typically have seen a more normalised through-the-cycle pricing around liabilities. But we will have to see how it plays out.

Omar Keenan
That is great. If I understood right, the flat NIM going forward from here assumes that we sort of get back to the 50 per cent pass-through?

William Chalmers
It is actually slightly different to that Omar. We have said our expectations are for the NIM to be broadly flat through the course of the second half. The pass-through assumptions that we have in our planning models are actually, as I mentioned earlier on, slightly ahead of the 50 per cent illustration that we see. To date, we have passed through less than that in line with the competitive conditions, the need to give customer service and value and the funding positions of business. We will have to see how we get on during the course of the second half, as said, it has been below that so far. But the planning assumptions are above, i.e. ahead of, more than, the 50 per cent in the illustration.

Omar Keenan
Okay great, thank you.

Question 3 – Jonathan Pierce, Numis
Hello there, just staying on margins if that is okay. Presumably exit margin as you left Q2 and entered Q3 must have been a bit above 287 basis points, given the development over the course of the quarter. I am just wondering whether you are, as is often the case, playing down a little bit the extent to which the margin behaves in the second half of the year. So hearing your comments earlier around mortgage headwinds intensifying and so on and so forth, totally understand that, but maybe give us a little bit more colour on what would maybe be bringing the margin back down if it did indeed exit Q2 at a level somewhere above 287 basis points?

The second question is really a broader question on the risk to this fabulous dynamic you are experiencing at the moment where you can pay deposit customers, even in interest bearing accounts, 20-25 basis points but then put that overnight with the Bank of England at 125 basis points. Either the risk of some form of political pressure to increased savings rates, or maybe more likely the Bank of England deciding at some point not to pay base rate in its entirety on the overnight reserve balances. So a broader question around sustainability of this fantastic environment you find yourselves in at the moment. Thank you.

William Chalmers
Thank you Jonathan. Maybe I will take the first one, and Charlie will comment on the second. In terms of where would the margin phase out. As I said, we reported a Q2 margin of 287 basis points. The strength of that over the first quarter is clear. I mentioned earlier on that we expect the margin development to be broadly flat going into the remainder of this year. That, in turn, is evident in our 2022 guidance of greater than 280 basis points which implies that H2 by definition is greater than H1. I talked a bit about

some of the headwinds and tailwinds, which will perhaps help answer your question. Tailwinds; bank base rate changes, deployment of the hedge, and funding and capital benefits. Headwinds; the mortgage turnover is expected to be greater in H2 than it was in H1. And so, if you step back and look at that, what could make a favourable impression upon that margin guidance? I think one is, the extent of base rate changes and the pass-on decisions associated with that being below our planning assumptions. So as I said, our planning assumptions are pass-on of more than 50 per cent. If we end up passing on less than 50 per cent it makes a difference both to income and to margin.

And the second point is around mortgages. We have in our planning assumptions seen a deterioration in the performance or rather the margin in mortgages over the course of Q1 and Q2 and interestingly, we are now seeing, as I said in my comments, that buck up a little bit. That is to say application margins strengthening. We are now in a position where application margins are ahead of completion margins and so that is pulling us back into a slightly more favourable place. If that dynamic continues, then the extent of that headwind in H2 that we are planning on for mortgages, obviously gets diluted by that dynamic and that in turn would result in a more favourable net interest income and net interest margin outcome. So that is a further dynamic that plays into the equation. But again, I think subject to that pass-on point that I just made, subject to that mortgage dynamic that I just made, I think broadly flat is not a bad planning assumption and then you see what there is around that. As said, looking back to where we were it is certainly a better picture, and the combination of strengthening mortgage margins and indeed the benefits of bank base rates, those two are a relatively powerful combinations for net interest income and net interest margin.

Charlie Nunn
Great and then Jonathan on your broader question, which is obviously a good question, a few thoughts. The first is we have not had any discussions with the Government or the Bank of England about any of those topics, cannot predict what may be in the future but we have not had any discussions on those topics. Second thing, which is more contextual, it is just worth looking at the Banking NIM over time. The NIM levels that we are guiding to here are still significantly below NIM levels for Lloyds Banking Group pre-Covid. And I do think that is important context when we think about the future and then how Government or the Bank of England will look at what we are doing.

And then, the third thing which you know very well is obviously, as William said, we are very thoughtful about our savings proposition for our customers. We are continuing to grow our deposits, and of course the other thing we know in the UK is that the vast majority of our deposits are with the top two deciles in terms of income wealth. And that is important because when we look at the analysis around customers that are struggling from a cost of living perspective it is not those customers. At the same time the margins on lending have really significantly tightened over the last twelve months, as you know. So I don't know how that is going play out from a political perspective, I am not a politician, but certainly no conversation on this to date. Historically we are not at high levels of NIM, and in terms of value for customers and how customers are trusting us on the deposit side and then the value we are bringing on the asset side I think there is a good story.

Jonathan Pierce
Yeah that all makes a lot of sense, thank you for that. Sorry can I just have one very quick follow up on this regulatory point. Just to check, you haven't encountered any sort of resistance at all on the distribution front, given the economic outlook is a bit uncertain, from the PRA to date?

Charlie Nunn
No, none.

Jonathan Pierce
Brilliant thanks a lot.

Question 4 – Rohith Chandra-Rajan, Bank of America
Good morning. I would like to follow up on the margin again. Your comments so far have been really helpful. I just would like to clarify them though if I could. In terms of the flat margin for the second half of the year versus Q2, I presume that you have probably still got about half the benefit of the 50 basis points of rate rises we had during Q2 still to come through, so we would see those in Q3. I just wanted to check that.

And then if I understand your comments correctly William, I think you are indicating that greater than 280 basis points for the full year assumes a higher pass-through than 50 per cent. So I wanted to check that is correct. And you are anticipating basically all the deposit benefits essentially being offset by mortgage repricing. I appreciate you said that mortgages have heavy maturities in the second half. But what are you assuming in terms of completion spreads for those mortgages? Is it the better application spreads that you are seeing are maintained or that we go back to the 60 basis points that we saw in Q2? So that is the first question, around margin dynamics.

And then the second one was just on credit quality. You sound very confident on credit quality and it sounds like you have been through the books pretty thoroughly. I just wondered if you could give some additional clarity on the thinking behind the £400 million costs of living reserves, so £460 million so far, and whether you can walk us through how that has been arrived at and what sort of scenarios it stresses for, for example, compared the severe downside scenario that you have in your IFRS models and which customer groups are covered? Thank you.

William Chalmers
Thank you Rohith, two questions there. One on the margin and some of the assumptions that we are making in the margin guidance. Two on credit quality and what is in the cost of living provisions that we have taken.

In terms of the margin, I have mentioned the dynamics that we see in the margin, so I won't go through those too much again. But to clarify on your question, when we have given that guidance for greater than 280 basis points, we are planning on our usual pass-through assumptions that we have deployed throughout the plan and indeed the plan we gave you on February 24th. Those in turn are above the 50 per cent illustration that we show on the slide that you can see in the pack today. So, if we see a pass-on that is below those levels i.e. below the planning levels, then that will accrue to the benefit of the margin. And as you can see from the sensitivity, what does that mean in numerical terms? Roughly 10 per cent reduction in pass-on equals £50 million, equals about 1 basis point of NIM benefit. So you can calibrate if you like the benefits that you get from the lower pass-on in the context of bank base rate changes. As you said, we have seen bank base rate changes progressively through the course of this year. And so what you will see in the H1 numbers is effectively the benefit of those base rate changes to the extent that they have accrued in the numbers to date. We make changes to customer pricing in line with base rate decisions and in periods thereafter, to the extent that any of those price changes have been delayed or alternatively accelerated. The check that we do as of June 30th to the accounts takes into account the extent to which that price benefit or cost has flowed through into the account. Therefore, as we look forward it may be that further benefits from base rate changes that are still to play out will accrue into the numbers in the second half.

You asked about the assumption on application margins and completion margins in the plan. When we look back to February 24th, as I said to you at the time, we were planning on 75-100 basis points by virtue of mortgage spreads. What we have seen in H1 is lower than that. We saw 85 basis points during the course of the first quarter which is clearly within the range. But then we saw completion margins of around 60 basis points in the second quarter which is below the range. As I said, what we have seen over the course of the second quarter is application margins starting to go up as swap spreads have stabilised, number one. And as the market has become more rational and relatively disciplined, number two. And so those application margins have started to creep up. Over the course of the last several weeks they have indeed started to exceed completion margins, so application margins are now above completion. If we were to stop the clock today, we look out at the market and application margins appear to be well within the planning range that we adopted on the 24th February. And so now, we have this reasonably powerful combination of base rate changes and the beneficial effect that has upon net interest income and margin, aligned to a mortgage pricing regime, which for the moment at least, is within our planning range. Now to be clear, that has gone up and down, but none the less that is where we stand today.

In terms of our plans, we had effectively calibrated our plans against the application margin as we saw it during Q2. And so that guidance of greater than 280 is based upon application margins as they were during the course of June, which is below where they are today, to be clear.

Rohith Chandra-Rajan
Sorry William, just to make sure I have got that right. What is baked into the margin guidance for the year is a deposit pass-through of greater than 50 per cent and mortgage application margins as they were in Q2.

William Chalmers
That is right. Now, again just to be mindful here. Two points to bear in mind in that.

One is application margins have been relatively volatile and they have been going up and down as swap spreads have gone up and down. But as we stand today, what you have said is exactly right and again, we are within our planning assumptions of February the 24th for application margins.

The second point is, before we get too carried away about the disappearance of the mortgage margin headwind, let's not forget that maturing mortgages were priced at 150-170 basis points, in that range, and they are now being replaced with mortgages that are within the completion application range that I just mentioned, which is materially above where these things were initially priced. There is still a mortgage margin headwind in place that will play itself through into our margin over the remainder of this year and beyond. But clearly, as the market improves, as application margins come up, the extent of that headwind starts to get diluted.

Your second question, credit quality. A number of points taken into account in the cost of living reserve. In the context of our £4.5 billion ECL right now, the cost of living reserve is £460 million. That cost of living reserve is built up of a combination of model developments, because our models are across the base case and really through the upside and downside cases, taking into account a more inflationary environment. We have also modelled a high inflationary severe, which in turn has a 10 per cent weighting in our overall ECL. A combination of those factors means that our models are naturally producing some cost of living adjustment for those higher inflationary pressures. On top of that, we have also taken some judgements, which take into account areas of the book that we think might be more exposed to the pressures induced by inflation. So to talk through one or two of those areas in line with your question, we have looked at sectors of the book on the retail side that are higher indebtedness for example, more exposed customers, and we have taken an additional provision for potential stresses that may appear in the context of that book. So that is a sectoral view on the retail side.

The second thing that we have done is adjust nominal for real incomes. Our models are typically worked on nominal incomes. We have taken account of the inflationary pressures and adjusted income variables for real factors and therefore taken into account effectively a model judgement for that nominal to real switch. So that is the second element. And then the third element that we have looked at is to look carefully at the sectors of our commercial book that may be more susceptible to inflationary pressure. Things like manufacturing where input prices have gone up for example, things like agriculture where again input prices have gone up for example. We have specifically taken those into account on a sector by sector basis to ensure that we feel comfortable with the potential impact from inflationary pressures and apply judgement in the context of those. Some of those taken at Q4 last year, £60 million as you say, just over £100 million, £109 million I think it was, taken as of Q1. And then we have taken a further £289 million as of Q2 in sum for inflation. You add those three up and you get to the £460 million that we have in the book for inflationary pressures as an ECL right now.

Rohith Chandra-Rajan
Okay thank you. So it covers both your retail and corporate customer basis where you think there might be some stress?

William Chalmers
Yes that is right, it is deliberately covering both sectors, again, in different ways as I have described, but it is covering both Retail and Commercial.

Rohith Chandra-Rajan
Thanks and if I could just have a very quick follow-up, what are the total management adjustments that you have currently got in place, so both for Covid and cost of living on top of your modelled ECL requirement?

William Chalmers
In terms of the judgements that we have in place, I'm going to take you through each of the areas of judgements and I will talk a little bit more about the numbers around those. We have three main areas of judgement within the ECL right now. Coronavirus related number one, inflation related number two, and so-called model limitations related number three, which is essentially where our models stop short of giving the full picture for example in things like past term interest only mortgages, some of the delayed repossessions that we have seen, we adjust for those. So take you through each of those; the Coronavirus related total provision right now for Coronavirus related issues is just a shade over £500 million. That is the total Coronavirus related provision. Now, £200 million of that is actually in the models. £300 million of that is applied by management judgement, including the £200 million central overlay that you will remember from previous periods.

The inflation adjustments, similar picture. We have got in total £460 million of inflation adjustments in the ECL as mentioned, but of those £275 million are judgements and the remainder is integrated into models. And then finally, model limitations that I described, that is about £370 million.

So those are the three components of the management judgements. Coronavirus is a £300 million judgement but do not forget there is a further £200 million embedded in models, equalling £500 million total Coronavirus related provisions. Inflation £275 million judgement, but again do not forget it is £460 million in total as a result of judgements and models.

And then finally model limitations, the type of past term interest only, some of the loss given default assumptions that we tweaked slightly to get results that we believe are the correct results, about £370 million. So hopefully that gives you a picture.

Rohith Chandra-Rajan
Yeah that is very helpful. Thank you very much.

William Chalmers
Thanks Rohith.

Question 5 – Raul Sinha, JP Morgan

Good morning, thanks very much for taking my questions. I have got two please. Just on capital, if we look at the very strong capital generation you have had in the first half of the year. Obviously, I think the outlook for the second half is probably not going to be as good as what you have delivered in the first half. I was just wondering William if you could talk about what you are seeing in terms of risk to procyclicality across the book from the current environment. And especially, if you were to consider a situation where interest rates end up, perhaps, being higher than your 2 per cent assumption, where there might be more risks both from an asset quality perspective and from a RWA or capital perspective? Then related to that the second question is around the timing of the next share buyback. Given the fact the PRA has delayed its annual stress testing result cycle and it is no longer going to be in December this year, pushed out into 2023, I was just wondering if that might create any risk to the size of the potential distribution that you might consider at full year results given the fact that you wouldn't actually have your stress test results by then?

William Chalmers

Yeah sure. Thanks very much indeed for the questions Raul. I will take the first question on capital, make one comment on the buyback, and then hand over to Charlie for the second question you raised there. In terms of capital, a couple of comments. As you point out, the first half capital generation has been very strong at 139 basis points. When we look at the performance over the remainder of this year, the right way to look at it I think is to take account of some of the H1 one-offs, for want of a better word. So, we have seen some tailwinds from RWA benefits around 20 basis points. We have seen some benefits from market volatility and consolidation of Embark, around 10 basis points. Those two together have offset the fixed pension contributions that we made during the first half of about 30 basis points. So that kind of nets off.

Second point is we saw a large insurance dividend in the first half; part of that was rates driven. That part, we don't see recurring and we will revert to a more run-rate contribution from insurance with capital picture in the second half.

The third point is we see a strong, but probably slightly softer, core banking contribution because as you know our costs tend to be weighted into the second half and again the investment picture will follow a similar sort of pattern. Plus, also impairments will start to normalise in the second half, and we are not forecasting the repeat of the release, and even if we did, because of the balance between EL and ECL right now, it is unlikely to result in the capital benefit.

So putting all of that together, take the one-offs out if you like, and then take account of a still strong but a slightly softer picture and that gives you the direction for the H2 capital generation which leads us to be very confident about the greater than 200 basis points. That is to say greater than is an important part of the guidance within that point.

You asked about procyclicality. It is an important point, obviously one that we keep an eye on. There is a range of models that we deploy through the business, so if you look at the retail piece for example, we generally have a through-the-cycle mortgage model, an important point. But on-the-other-hand, some of the CRD IV developments are moving it to a slightly more procyclical stance. So a little bit of movement there, but is basically founded upon through-the-cycle model. Other elements of retail are a bit more point in time. Now, I would stress in making that comment, that as I said we are seeing no underlying signs of deterioration in the book. We see it as a prime book and therefore we are very comfortable on it and we have seen no credit migration during the course of the first half. So although other retail models are slightly more point in time, and therefore perhaps a bit more sensitivity, I don't think we anticipate any significant movements or any large movements.

Moving onto Commercial; Commercial as you know is built upon a foundation IRB approach. That in turn means that we use regulatory described loss given defaults, and it also means that we are therefore much more through-the-cycle. And so we expect Commercial Banking procyclicality to be very limited because of that FIRB point that I made. And we saw that during the Coronavirus crisis, even with quite significant downgrades, we saw very limited procyclicality in the commercial books. And we expect, you know if we do see a serious downturn here, which as you know is not our base case so much, but if we do see a serious downturn we expect again very limited effect in the commercial book because of those reasons.

Final point on this, by way of sensitivity we have looked at the relationship if you like between HPI and mortgage RWAs to give you some idea of some way to gauge that. We think a 10 per cent drop in HPI leads to around a £1-1.5 billion mortgage RWA increase. That hopefully gives you a basis on which to calibrate how the book might respond to such a scenario.

Second question on timing of buyback, a couple of points I will make and then I will hand over to Charlie. Timing of the ACS as you know is second half of this year. We have not seen the assumptions for the ACS so we can't obviously comment upon those but you know that we passed the last ACS in a very significant UK focused stress. We have today as you know a very strong capital position of 14.8 per cent. We also have a very strong capital generation, greater than 200 basis points. So we deploy that in the context of delivering growth that you have seen today and based upon everything that we know today I would have thought, subject to the board decision of the appropriate time, I would expect us to be in an excess capital distribution discussion. But perhaps I will stop there and hand over to Charlie.

Charlie Nunn

Thanks William. The only thing I would add is, because I agree with everything William has said, we obviously don't know the nature of the stress yet, I do think the context of the PRA reintroducing the 2 per cent countercyclical buffer is important. And as you know that is fully incorporated in our capital stack and our guidance, around in the medium term, our 13.5 per cent CET1. So, introducing the full 2 per cent stack in the potential middle of what could be a softer economic environment, I think is partly around good capital management from their potential perspective. And it feeds into this discussion, I expect that when we get to the conclusion time for the ACS findings it will give confidence that we have built the right capital stack at that stage. So, we are committed to distributions as are appropriate as William has said. We will make those decisions at the end of the year. Capital build is strong, and we already have the full 2 per cent countercyclical buffer in our 13.5 per cent CET1 medium-range target.

Raul Sinha

Thank you very much.

Question 6 – Chris Cant, Autonomous

Good morning thanks for taking my questions. If I could come back to slide 11 please and you have given us that quite interesting looking disclosure around the sensitivity of your sensitivity to the beta inputs. Could you just help me to square the circle on that please? So, if each 10 percentage point reduction in the assumed beta adds £50 million for a 25 basis points hike, that would seemingly imply managed margin deposit balances of about £200 billion. But the £175 million sensitivity for a 50 per cent pass-through on a 25 basis points parallel shift would imply at most £140 billion of managed margin deposits. And if I assume some hedge roll within that £175 million, probably more like £100 billion or £105 billion of managed margin deposits. So how should I think about this, I mean put it another way. If each 10 per cent change in the beta is £50 million for a 25 basis points shift, how is a 50 per cent beta assumption within your parallel shift sensitivity not equal to at least £250 million of NII sensitivity with then the hedge churn in fact on top. I am just really struggling to square those two statements on slide 11.

And then my other question was on slide 15. So, when I think about the size of your structural hedge, as rates go higher, what are you assuming about customer behaviours in terms of a move back out of current account balances into non-current account balances? Obviously, you have increased progressively the size of your hedge capacity. It is now 48 per cent of the balance sheet notional you show on the slide. And if I go back to the end of 2019 for instance it would be about 41 per cent. So, you are saying more and more of the balance sheet is hedgeable because of the growth in current accounts, but what if anything you are assuming about the behaviour there as rates go back up again please? Thank you.

William Chalmers

Yeah thanks Chris. I will give you an answer to the first question but I will also just make sure you are connected to the team here in IR to go through any particular numbers you may have on your spreadsheet which they can square with you. And then obviously the second question, more than happy to go into. In terms of the sensitivity that we are showing on the hedge, as you know the sensitivity of £175 million is composed of a number of different features so we have repricing lags, relatively modest component of the overall £175 million. We then have hedge maturities. In the first year, obviously a relatively modest component of the £175 million, because you have got a hedge roll if you like that takes place gradually over time, but it becomes more significant over time as that hedge roll cumulatively increases. You have then got reinvestment of the buffer, and indeed the uninvested part of the buffer contributes around 25 per cent or so of the £175 million that I mentioned.

And then finally the margin management which goes to your pass-on question, which contributes around 50-55 per cent of that overall £175 million. I think the reason why you are seeing more the sensitivity than you do in terms of the pass-on sensitivity the 50-40 per cent, is because when we reduce the pass on by 10 per cent, essentially what you are getting is a 10 per cent contribution from a 25 basis point increase applied to the invested deposits. And if you run those multiplication sums through, that is what arrives at the £55 million. In terms of the components of the £175 million, as I mentioned earlier on those will be numbers you are familiar with. So the structural hedge maturities, that is contributing as said around 15 per cent or so of the £175 million. It is a combination of the maturities we expect to see, on average, over the course of the year applied to the 25 basis points. The buffer, likewise, it is the on average maturities, sorry the buffer applied 25 basis points and so forth. So beyond that Chris, I will direct you to the team to kind of compare the spreadsheets if you like. But the particular point you are worried about the, 10 per cent pass-on, how does that contribute £50 million. The simple answer to that is to take 10 per cent times 25 basis points times the structurally hedged or interest rate insensitive deposits that we have. You mentioned the number of £200 billion. I won't comment on that precisely, but it is a little bit north of that and you are not far off.

The question that you had in relation to page 15, Chris, I think it is probably easiest answered by giving you a sense as to how we are looking at the hedge and indeed how the dynamics of the hedge have progressed since roughly 2019. The hedge, as indicated on the slide, is at £250 billion right now. We are in currently a neutral position given developments within the market, we have chosen to deploy the hedge. We have seen an increase in hedge capacity of about £65 billion since 2019. I think your question relates to, where does that come from and what is our exposure to deposit type activity and changes in deposit behaviour. The best way to answer it I think is of that increase in deposits that I mentioned earlier on of almost £70 billion that we have seen since 2019, we have probably deployed around £40 billion of that into the structural hedge. Where's the rest of the increase in capacity of £65 billion come from? So where has the other £25 billion come from? It has come from two things.

One is increased deposit eligibility of the existing deposits that we had. So we have looked very closely and worked with various aspects of the book, including on the commercial side to make sure the existing deposits are better managed and therefore more eligible for the hedge going forward, more static, less interest rate sensitive. And then we have also looked at prior buffers that we had in place previous to 2019 and some of those have come into play as well. So the overall makeup of £65 billion increase in hedge capacity is coming about £40 billion of deposits taken from that roughly £70 billion increase that I mentioned earlier on. A further £15 billion, approximately, of deposit eligibility and then prior buffers making up the remainder. That gives you some idea of the composition of the increase in hedge capacity, which in turn allows you to note the fact that the buffer during that time for the structural hedge has gone from roughly £9-10 billion to roughly £30 billion. So, we have tripled the size of the structural hedge buffer and at the same time we have £13 billion of maturities this year and £35 billion of maturities next year. All of that gives us significant flexibility for any change in deposit behaviour that we might see.

Now of course, we plan prudently and we don't invest deposits that we think ultimately might become interest rate sensitive. But in the context of a buffer that is tripled, in the context of maturities of £13 billion followed by £35 billion, hopefully that gives you some comfort that we are not being too aggressive in terms of investing our hedge. We really don't think we are, we think we are erring on the side of prudence and we think that the behaviour over the next couple of years will bear that out.

Chris Cant
Okay thanks I will follow up with IR on the first question, thank you.

William Chalmers
Thanks Chris

Question 7 – Guy Stebbings, Exane BNP
Hi, thanks for taking the questions. Firstly, I wanted to come back to margin, I know you don't want to guide beyond 2022 but if we could think about some of the moving parts as we look a little bit further out. I guess there might be a slight concern that given your guidance to flattish NIM in the second half of this year despite some sizeable rate tailwinds to work through and what that might mean as rate tailwinds fade next year. As I guess in particular how much of a mortgage margin headwind we should be thinking about beyond 2022 or is that largely confined to the second half of 2022 rather than 2023, I mean looking at historic pricing that seems to be the case, but just helpful if you could comment around how much we should be thinking about that rolling into next year some of that mortgage headwind?

And then the second question was just on volumes and the interest earning asset guidance which has a bit more favour than expected, and you are talking to further growth in the consumer book with good discretionary spends on cards. I guess that isn't what we see and hear sometimes in terms of the most recent consumer spending data. So, I am just intrigued around your conviction levels on consumer lending growth in the second half this year. And on mortgage lending, which remians remarkably resilient, are you seeing any slowdown now in the pipeline, perhaps as we have got to reflect about higher mortgage rates? Thank you.

William Chalmers
Yeah thanks very much indeed Guy. On your first question can I just check I understood properly. Would you mind just repeating your first question again Guy?

Guy Stebbings
Yeah certainly. So I guess your guidance, which given some of the questions people might say, is struck slightly conservatively, but on face value you are talking to flat margin in the second half of 2022 even though we have got a lot of rate tailwinds still to work with in the numbers i.e. we have got big offset coming from mortgage spreads. So just trying to understand how isolated is that to the second half of 2022 or should we think about some of those mortgage spread headwinds still working through into 2023 at which time maybe the rate tailwinds fade.

William Chalmers
Thank you Guy. I will take the first question on margin. I will make one comment on AIEAs and then hand over to Charlie on general trend we are expecting to see in terms of customer behaviour and balances. In terms of the margin picture, we are seeing our guidance increase to greater than 280 basis points, we expect that to translate into broadly flat margin for Q2 as we go through the remainder of this year with the Q2 start point of course being 287 basis points. What does that mean in terms of the components within that? I talked about the second half seeing an increased role of the mortgage headwinds that we will see and that being a slightly more important factor in terms of offsetting some of the benefits of the base rate rise and indeed the deployment of the hedge. That mortgage headwind is a factor that starts to build up in the course of H2 of this year and because of the nature and the term of the mortgages that we wrote during 2020 and 2021, inevitably that continues into 2023 and a little bit beyond. And we will get past the worst of that mortgage headwind, if you like, by the end of 2023. It is the 2023 year that is probably seeing most of that effect.

Now a couple of points to make in addition to that are, as we have been discussing throughout this conversation, as we application margins improving, if they stay at the type of rates that we are seeing today, the extent of that mortgage headwind is going to be diluted not just for the second half of this year but also for next year. But nonetheless don't forget that even if application margins are, let's say 80 basis points, that is 80 basis points replacing the 150-170 basis points, that this stuff was written at in 2020 and 2021. So there is still a reasonable gap there. But as said, could be diluted if we see continued progress in terms of application margins such as we are seeing at the moment.

In terms of the hedge as I mentioned a second ago, we are now fully invested in the hedge, but we are seeing rolls of £13 billion in the second half of this year, £35 billion next year. And two effects to note there, one is that we have already, through deployment of the hedge, built in considerable progression in hedge earnings next year versus this year and indeed the year after that versus 2023. So, we are seeing continued progression in hedge earnings off the back of what we have invested right now. And then as those rolls take place, if swap rates stay at rates such as they are now then we will benefit from those rolls as they go forward. So, we do expect meaningful progression in hedge earnings over the course of the second half of this year and indeed beyond and those are factors too.

And then finally in terms of base rate we are expecting a base rate of 2 per cent at the end of this year, we have then got one more rise going into next year. We will see how those take place and also how the pass on assumptions differ, or are the same, as our planning assumptions. That is a source of further support in the context of the overall margin and net interest income.

So hopefully that gives you some idea about why we say we expect the margin to be flattish second half of this year and a picture as to how we see the gives and takes thereafter. I will hand over to Charlie on kind of balance sheet as we expect to play out second half of this year, but I will just leave with one point which is the guidance that we gave at the beginning of the year which is low single digit AIEAs remains in place. So, I don't think any of the comments that we have made or intended to make would change that picture at all with slow single digit AIEAs. Probably not terribly different to some of the patterns that we saw in the first half.

Charlie Nunn
Thank you William, that has set up the macro scene that you should definitely take away, but maybe a bit of colour that will be helpful just on unsecured and credit cards. As William said a couple of key points there. First of all, 90 per cent of the spending that we are seeing is medium and higher income families and obviously that is really important when we look at sustainability of spending and then the ability for those customers to sustainably manage that debt they have with us if it converts into debt. So that is the first point and that is why we believe there is likely to be some increased continued spending in that space. When you unpack that, there is a couple of things happening on our card spending.

First of all, customers are stopping some of the good's spending, which when you look at the retail data would come through so white goods, computers, department stores are actually down 20-30 per cent year on year. As you all know, actually goods spending went up significantly during COVID, but they are all down year on year but then travel, restaurants, pubs, some of the services spending is materially up. Travel is up 300 per cent year on year and is up above now where it was pre-COVID. So, there is a shift away from goods into services and there is still strong spending through the higher income customers which means, we will have to see what happens, but gives us confidence, as William said, for that signal digit AIEA growth.

On mortgages you will have seen the data. There is already a softening in the mortgage market, both supply and demand of houses as a leading indicator of how the mortgage market will come through. At the same time however, there is obviously a stronger re-mortgage market going on, as customers are looking at rates and trying to lock in better rates. One of the obvious, but important, dynamics in that market is there has been a shift, we have talked about in the past, a 50/50 split between a two-year, five-year fixed mortgages. There has obviously been a meaningful shift towards longer-term mortgages. And all of that again, we expect to continue to play through into the second half in our baseline unless there is a materially different outlook.

Guy hopefully that helps and gives you a bit more colour.

Guy Stebbings
Yes that is helpful, thank you.

Question 8 – Martin Leitgeb, Goldman Sachs
Yes good morning. First of all, also let me echo the comment on the good numbers today. Could I just comment firstly on earlier comments on mortgage pricing? I was just wondering what, in your view, is driving the improvement in mortgage pricing you have seen recently? Is there anything interesting to call out, is there any increase in the mortgage volumes with maybe some borrowers trying to fix in the rates before the increase in swap rates or is this a kind of more rational behaviour of market participants you attribute the improved pricing trends to? I am just trying to understand how to think about these pricing trends going forward.

And secondly, more broader question. Lloyds revised upwards the revenue guidance or income guidance twice this year. And I was just wondering if there are any potential offset to that going forward? Offset either in terms of cost or in terms of impairment. So compared to when you laid out your 2024 targets earlier in the year, inflation has come in higher. Does this make it more challenging to meet the 2024 targets for the cost progression? And equally, in terms of asset quality, much higher mortgage pricing, cost of living squeeze. Could there be risks that we might see some offset from the higher income trend today on costs or impairment, say in 2023? Thank you.

Charlie Nunn
Thanks Martin, so let me take the first one and then William can, even though we are not guiding to 2023/24, give you some perspectives on that in terms of cost and impairment. So just on mortgage pricing. Obviously, we can only know what we are doing as an organisation, we don't know what our competitors are doing. But our perspective on that is it is not about some change in perspective on risk or idiosyncratic risk. We think it reflects more that we have just had a period of stability around swap curves. And as you will recall through the first two quarters, there was a lot of volatility and change in the swap curves and we talked on previous calls with this community, with this group, around how some of our competitors would take 2-6 weeks or 8 weeks to adjust their pricing, partly because they may have locked in their own rates around their own swaps activities. So, we have had a period of stability, it has been flatter, in fact there were some declines in the swap curves more recently and we think competitive pricing has therefore kind of normalised or stabilised in that context. I think, just as you look forward then, in that context, if we see more stability around it then we will get to a stable equilibrium that we will be able to report on and share with you more broadly going forward. If you start seeing additional volatility, up or down, I think we should expect market pricing to take 2-8 weeks to adjust or 1-2 months and you will see some of the behaviours we saw in the first quarter and the second quarter.

One more thing from us, you will see that we have continued to position ourselves and price in a way we think is good value for customers but also making the right trade-off between value and market share and we have been trying to very rationally price through this dynamic environment. And hopefully you have seen that. William, second question?

William Chalmers
Thanks for the questions Martin. You asked about inflation and its effect on the business, both in costs and impairments, and there are one or two other points I will add. In terms of the impairment picture, we have taken account of the inflation in terms of the ECL that we currently have, in the context of the economics as we have portrayed them. As you know, that implies a base case which sees inflation peak at 10 per cent in Q4 of this year, but importantly it also implies a weighting for the high inflationary severe scenario which sees higher levels of inflation of around 14 per cent again later on this year. The inflationary pressures that we are seeing are very much incorporated in ECL. How is that done? That comes back to the answer to the question earlier on, which is around the models that feed their way through into expectations as to losses and those that have had fed their way through in the course of the £460 million total inflationary adjustment that we have taken. And then also part of that, the post model adjustments that we have taken again assimilated into that overall £460 million ECL component accounting for increased inflation. And those have been both within the retail space and also within the commercial space. So overall, the ECL contains the inflationary pressures that we expect to see including base case and including the severe downside scenario. Those are contained within the £460 million inflationary provision that we have within the ECL, which is a combination of models and post model adjustments that we have taken.

A further point here is that the model is coherent and so the asset price effects of those inflationary tendencies, for example on house price indices, are contained within our overall expectations of economics in a coherent fashion and again feed through into the ECL. Inflation in terms of its direct effect, inflation in terms of its indirect effect, are part of the coherent model that in turn is embodied in the ECL. Now clearly, if assumptions change, then you can expect to see an ECL change with that and hopefully the sensitivities that we provided at the back of the pack gives you some idea as to how the ECL might respond to that.

Moving on to the second component of inflation, how is it influencing our cost base? We are clearly seeing some inflation. We are not immune from inflation. Where are we seeing it? We are seeing it in the context of wage pressures, we are seeing it in the context of variable compensation, we are seeing it in the context of relationships with suppliers. But importantly, we are good at cost management and so when we look at those variables, ones we have built into our existing plans, expected increase in wages, expected increase in variable compensation. We have also long-term supplier contracts, which will take us over the course of this year and into next in ways that effectively lock in matrix price agreements with suppliers. Likewise, we have forward purchased much of our energy commitments for this year and for next, which again, gives us some certainly around the cost base there.

And then finally, we obviously resort to our strong matrix management and third party supplier management in terms of ensuring that we are able to absorb any unexpected increases coming from inflation. For example, our compensation of £1,000 to employees that we announced earlier on this year. We are able to absorb those types of shocks by virtue of our BAU cost management, which in turn gives us the confidence to say that we will be delivering on our cost commitments for 2022 and there is really no room for question or doubt around that, in line with our delivery in prior years, again on cost commitments.

Final point is I am sometimes asked about what the effect of inflation is on the pensions plan. The pensions plan are very largely hedged. So if you look at it on an actuarial basis or an accounting basis, the impact of inflation there is very largely hedged and indeed we have been making sure that we are increasingly protected for the deficits that we see going forward as we approach the funding round at the end of this year so that we are not taken unaware or surprised by the effect of inflation. We are effectively locking those in on top of the existing hedges that we have.

I will perhaps stop there but Martin the short answer is that inflation is taken account of for our asset quality judgments as we stand today, and clearly as economic assumptions change then we will change with that. But as we stand today our expectations are that we have taken account of them. And in turn, inflation is taken account of in our cost basis and our commitments. And finally, the inflation is taken account of in the context of the pensions management that we adopt, and indeed as we look towards the end of the year that becomes increasingly important.

Martin Leitgeb, Goldman Sachs
Thank you very much.

William Chalmers
Thank you Martin.

We will just say thank you for everybody for joining this morning. We appreciate the questions and appreciate your interest in the business. Thank you very much indeed.

Charlie Nunn
Thank you.

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FORWARD LOOKING STATEMENTS

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