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

Tuesday 6 September 2022 – 4.00pm

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William Chalmers
Thank you to everybody for joining this afternoon. As you saw at the HY Results at the end of July we showed a set of results with strong performance and continued confidence in our delivery. The P&L and the balance sheet and the capital generation together allowed us to enhance guidance for 2022. Alongside that it is obvious that external challenges have intensified, have changed in the several months that we see proceeding today, including over the summer, and we are cognisant of that. At the same time the business performance has not changed. We show continued progress alongside the strategic plan implementation which we embarked on and talked to you about on February 24th.

So those are some comments I thought might be useful by way of introduction. Perhaps at this point just happy to turn over to Q&A. So over to you.

Question 1 – Rohith Chandra-Rajan, Bank of America
Hi, thank you very much for doing this and as you just said William, things continue to move very fast. I wondered if you could maybe help us, first starting with the ECL thinking about both in terms of the modelled ECL and then the £0.5 billion you have got in terms of inflation risk I guess, or cost of living. How should we think about if there is a way to flex that to reflect changes in inflation expectations or energy prices for example? That would be the first one.

And then the second one just on mortgage pricing and the very sharp move we've had in swap rates in recent weeks. Just wanted to assess your level of confidence that you can pass that on through to mortgage rates in the coming months and how long you think that could take if you think it is possible. Thank you.

William Chalmers
Yeah, thanks very much Rohith and thank you for the question. A couple of points maybe on the ECL. The ECL as you know at H1 was £4.5 billion. Within that, to your point, we have £460 million embedded in that to account for cost of living impact covering retail and commercial segments. And that was a split of modelled ECL and then also some PMA, roughly about £180-190 million of models and about £275 million of PMA. When we look at those, those were targeted to your point around those segments that we felt to be vulnerable i.e. high indebtedness segments on the retail side. Plus also those segments on retail where we felt there was a risk of increased loss from the transition in real and nominal incomes. So we took a measure to effectively measure peoples incomes by real metrics as opposed to nominal metrics, recognising that inflation is an increasing factor.

And then on the commercial side we took a series of measures to recognise those sectors that were most exposed to higher raw material costs in general, but higher energy costs in particular. And so to your point there is a sense in which that £460 million is very much targeted at those sectors that we felt were most exposed to inflationary pressures generally, but specifically the driver of that being principally energy costs. Now a couple of points that are worth making since then. One is the £460 million measure is as of our economics including our expectation of energy prices as of HY. I think it is only fair to point out that, as you did in your question, things have progressed a little bit since then including obviously energy costs. But the £460 million position very much covers that position as of HY. We await with interest to see what the Government measures are and how far those are going to pin back energy costs from rises that would otherwise take place. And again, how much that then reconciles with our expectation for energy costs as of HY. And it may be that the effect of Government measures brings us back closer to the assumptions that we had as of HY and the £460 million should be seen in that context.

The other point on ECL which I would make is our Covid balances, which as you know are around £300 million of PMAs effectively for Covid related issues. About £200 million in the models, about a further £300 million on PMAs. I think the model £200 million will run itself through as we see the experience of defaults in the commercial and retail book that we previously thought was somewhat stored. But the £300 million of PMA within Covid as you know is effectively £200 million at least as an overlay of risk against, or insuring ourselves of risk against, further strains of Covid. If we don't see those then we will look at that Covid release and that is when we look at our overall PMA picture in the context of unexpected events as it were, whether it is cost of living or whether it is Covid strains. It is just worth keeping that additional piece of information in the back of your mind.

That is the first question, Rohith. On the second as to mortgage rates and swap rates, as you point out it has been quite a striking increase in swap rates over the course of August and into early September. And that has changed the picture for mortgage spreads. I think when we talked at HY we talked of completions at that point of 60 basis points. We also talked of application margins that we are significantly ahead of that. And we saw a picture in August where application margins looked like they were around 80 to 100 basis points in that zone for a period of time. We then obviously had the swaps run up and that has led to a sharp compression in overall mortgage margins. But it is encouraging to see that there is a material level of repricing now on going within the market. Having said that, swaps are still volatile so predicting exactly what the pattern will be and when it will settle is a little difficult. But we take some heart from the fact that spreads, completion and application, were heading into our plan territory during the course of August before that rally in swap prices. We also take some heart from the fact that we have seen some material repricing right now.

I think what you have to see is a couple of things. One is you have to see the fixed money that people still have on their books for mortgages playing itself through before you get stability within mortgage pricing. And then secondly you also have to see a period of swaps stability for that mortgage margin to really be stable going forward. I think what we are seeing right now is, after a sharp period of compression the last couple of weeks, a period of expansion. And as said, if we are looking for data points in that respect, we go back to where we were at HY with the outlook on application margins that we had then.

Rohith Chandra-Rajan: Further question
Okay thank you. Could I just clarify a couple of things just on the first point which is that your ECLs that you have in place including the overlays are based on energy prices as at HY, they weren't forward looking.

William Chalmers
They were forward looking. Sorry Rohith, go on, go ahead.

Rohith Chandra-Rajan
I think the second point around that was just that there is some residual Covid overlay that you could potentially release and that could top up the cost of living provision if I understood that correctly.

William Chalmers
To comment on each of those two Rohith. The futures prices that we had in our modelling as of the economics of HY were very much forward looking, but they were based upon the futures curve. We don't try to do anything other than take the futures curve in making our model forecast. Now what happened since then as you know is that the actual energy prices that were declared were ahead of where the futures curve was as of HY. And my point to add on to that was that the Government measures that we await to see over the course of the next week or so may well bring those actual energy prices back to something that is closer to what we were forecasting as of HY. So that is what I was trying to get at there.

On the second point I have always maintained and will continue to maintain that any cost of living charges are separately built to any Coronavirus charges that we may incur. They are separate drivers and separate estimates if you like and they should probably stay that way. But my point is more that you have got a cost of living pressure which is seen increasing subject to whatever it is the Government might do, and you have got a Covid pressure which is decreasing. And so I have often been asked before as to whether or not there is some interchangeability. In a strict sense no, but on the other hand one pressure is going one way and the other pressure is going the other way.

Rohith Chandra-Rajan
That is great, thank you.

William Chalmers
Thanks Rohith.

Question 2 – Omar Keenan, Credit Suisse
Good afternoon William. Thanks very much for making the time today. I have just one quick follow-up question on the ECL provisions and then a second question on deposit beta. On the ECL provisions, I appreciate that what happens with the cost of living situation and sort of more general UK GDP expectations, you know we might understand a little bit more on that in the coming days depending on what comes from the Government. Could you perhaps help us a little bit with the sensitivity of the ECL models to interest rates? I guess just the sort of question I had in my mind is for

any particular GDP outcome you know if we assume a higher level of interest rates then what is the sensitivity of the ECL requirements and for that?

And then my second question on deposit beta I was hoping that you could perhaps just give us a little bit of colour maybe as to how deposit balances are behaving since the end of June and what you are seeing competitively in the market?

William Chalmers
Thanks for those questions Omar. On the ECL, a couple of points in relation to sensitivity and rates. One is as you know we publish sensitivities on HPI and we publish sensitivities on unemployment in relation to the ECL, and you will see those in our disclosures. But for the sake of completeness, unemployment, 1 per cent increase in unemployment is about £100 million, 10 per cent reduction in HPI is about £200 million. That gives you an order of magnitude. But we don't typically publish sensitivities on interest rates. It is I would say as a generic point relatively limited at current levels to the extent that we do disclose the best place to guide you to is the economic scenarios at the back of the results publication that we put out which gives you some sensitivity as to what we might look like in the context of higher interest rates in each of the scenarios that you see, in particular the down side and severe downside as examples. The severe downside in particular is a higher inflation rate scenario which may be helpful. But there are clearly a number of other moving pieces in that analysis. So just interpret that with a bit of care.

A further point I would make Omar to that point on ECL is that as said, the overall sensitivity to rates is relatively modest. What is a big driver is unemployment in addition to what I just said around the scope of that and HPI. Those are the metrics which really drive and that is why the disclosure is really focused on those areas.

Deposit beta, we said at HY that we look at deposit beta in the context of value to the customer first and foremost, offering great value to the customer. In the context of the competitive environment and in the context of the funding of the business. And taking each of those three metrics in turn. Value to customer, we obviously pay a great deal of attention to, I will come back to that in just one second in terms of what that has meant for the pass on. In terms of the competitive environment to your question we have seen, I would say, fairly uniform behaviour from the competition actually. Again I will come back to what that means. But if you look at what the competition has done on the pass on topic it has tended to move pretty much in the same direction at pretty much the same time to pretty much the same quantum. And you know I think that is a reflection of the fact that we started out at relatively low interest rates, that people have started to pick up pass on as those interest rates have risen. And indeed there is an expectation that as interest rates get higher, then we will gradually pass on more to deposit holders at that time.

And then finally on the funding of the business, as you know we have got a loan to deposit ratio of 95 per cent and that makes the business feel very comfortable from a funding perspective. And therefore of the three constraints that I mentioned that is probably the least important of the three of them, in current conditions. The final point Omar to give you some context here the pass on behaviour that I was referring to for the industry as a whole, I think over the course of this year and the context of about 165 basis points of base rate rises, it has been around 20 to 30 per cent for the sector as a whole. We see ourselves as very much in that mix. But as you can tell from that comment it is a pretty bunched up type of behaviour for the sector as a whole. And that I guess answers the question about how we see ourselves and how we need to respond to the competitive environment.

Omar Keenan
Okay thank you very much. Could I just ask a quick follow-up question on the deposit question. Since the end of June have you seen any significant change in customer behaviour for example deposit mix shift or anything like that?

William Chalmers
Sorry that was part of your question I didn't answer wasn't it Omar? In short the answer is no, I think the trends that I would point out is as you know we had very significant deposit gathering during the course of the pandemic, and indeed afterwards, almost £70 billion of deposits since the end of 2019. That has been accelerated during the pandemic. The pace of growth however has slowed in the course of recent months and so, I won't give any precise numbers around what has happened during the course of July and indeed into August but, I think what we have seen is still continued deposit flows. But on the other hand the pace of that growth slowing. And that, you know, in a way is what you might expect as a result of people getting back to normal daily activity post the pandemic. And I have no doubt, also, to an extent them having to spend more money on other goods that they previously hadn't spent as much on because of inflationary factors. I think both of those two trends are in place. But I think to your question, the main characteristic that I point out is we have seen a slowing of that deposit intake by the business albeit directionally at least it continues to be consistent with what we have seen in the periods prior to that.

Omar Keenan
That is great, thank you very much.

William Chalmers
Thanks Omar.

Question 3 –Alvaro Serrano, Morgan Stanley,
Hi William. I have a couple of follow-ups and a new question. Just taking on the deposit float. Any commentary you could add in terms of are you seeing a shift from overnight instant access to term deposits where it is the term deposits where the more generous remuneration is so I guess at some point that we are a bigger flow into that and change of mix I don't know if you are seeing any of that? Related to the NII, and then I have got a question asset quality (a follow-up on asset quality); there is increasing chatter on this on the possibility of Bank of England changing the remuneration on reserves, it comes and goes, but at least I am getting inbound from clients. The question there is, if there is some sort of tiering system where they reduce their remuneration reserves, should we assume you can find another source of parking the cash where you can find similar remuneration? Is that something you can manage, or any thoughts on the feasibility and what the implication of that is?

And the third is really on asset quality. You have mentioned the overlays and the sensitivities but traditionally all those sensitivities around unemployment rates, house prices at the very standard metrics. I wonder how confident are you, in particular in the corporate, do you have enough information around sort of energy inflation and what could be a real impact on corporate asset quality? How can you transmit the assurances that there is a good grip on asset quality because on the real estate side it is more plain vanilla and we are used to it. I am not sure we have the granularity. I don't know if your information systems have a granularity or we can have the same level of conviction, anything you can tell us on that to reassure us would be great.

William Chalmers
Thanks Alvaro. Three questions there; I will take them one by one. Interest, or rather instant access to term; the short answer is no, we haven't really seen any significant movement on that side. Now I think the answer, or sorry the reason, for that really is that interest rates are still relatively low. And that in turn means that the gains for people from switching from one, which clearly has convenience factors attached to it, to another which has a higher price attached to it; that gain is still relatively modest compared to as said the friction from no longer having instant access that they may have. So the sure answer to that is no, I mean there is going to be some at the margin clearly but it is not a trend that we are discussing as a team. Having said that, I would expect that to pick up as we go into a higher rate environment as the opportunity cost of having your instant access starts to change. And so although we haven't seen that activity to date I am sure it would pick up as we go into a higher rate environment as the front curve suggests.

Having said that I guess the third point on this topic is that so naturally will our pass on. I mentioned earlier on that the pack for pass on has been around 20-30 per cent pass on since the base rate changes started happening at the beginning of this year. You will have noticed that we upped our deposit rates basically 20 basis points out of the 50 basis points rise in August just last week I think it was. That is a 40 per cent pass on. So you can see that pass on is starting to tick up a little bit. I won't be too prescriptive about exactly what form it takes in the coming months. But my point is just the direction of pass on, it tends to go up a little bit as interest rates rise. And that in turn will influence, clearly, the instant access into term savings account patterns that you might see. So I would expect to see more of it and some of it will be encouraged depending upon where the rates are given to different products.

Second point on NII, on the remuneration issue it obviously does come up in conversations, you are quite right. I guess two or three points I have made. One is that we are having and have had no conversations of this type with anybody in the kind of regulatory authorities, Bank of England or otherwise. So we know as much about it as you do in short. The second is we do look at, and take some comfort from, the statements of policy makers and often politicians around their position on this. And you know whether they see it as advisable from a policy perspective. And that obviously goes right to the transmission of monetary policy and whether or not such a policy will interfere with that. So we take some comfort from the comments around that, but clearly the pressure may rise in the context of rising base rates which exacerbate the issue. And maybe more media attention so forth paid to it. We will have to see.

To come to the final point on this topic which is to your question Alvaro, if we were to see that type of tiering applied it will apply to our reserve balances. I am not sure whether we disclose our observed balances or not. But we expect to have a meaningful way of offsetting any such tiering by redeploying some of those reserved balances, clearly not all, some of those reserved balances in other locations. And so you know I won't claim for a minute that if the reserve of remuneration were scrapped on the totality of reserved balances we wouldn't see some negative impact, we would. But we would expect to be able to redeploy and offset significant part of that reserve impact with effectively investing in other liquid assets that would satisfy our constraints. So that is the best way to answer it for now.

The third question, energy. The energy is something which plays into all of our forecasts in a macro way. So if I go back to the comments that I was making around I think it was Omar's question around energy or sorry Rohith's question around energy prices in our forecast. When we look at HY we took, again as I said, the futures curve. And the futures curve at the time was indicating about a 42 per cent increase to about £2,800 for energy prices at that time. In fact Ofgem came up with an 80 per cent increase to about £3.5 billion, sorry, £3,500, apologies. And so we have seen some of it goes beyond our macroeconomic forecasts in that event. And that is why the third quarter we will take another look at our macroeconomic forecast. We shall consider that and we will also consider whatever the public, sorry the public authorities, the Government response might be. In terms of what does that mean for our clients therefore, let's focus on the corporate for now, but probably the comments could equally be applied to retail. For the types of energy increases that we have put into our forecasts those were therefore embedded in our ECL as of HY. To the extent that energy prices rise above and beyond that, that is again to be considered as of Q3. But again I would probably draw your attention to what might that mean in the context of our scenarios that we put in, the economic scenarios, that we put in the back of our disclosures. So you will see if those energy futures translate into a picture that looks more or less like our downside which is around a 6 per cent unemployment rate, around an inflation of I think it is about 8.7 per cent thereabouts, HPI down by about 7.5 per cent, all of that in 2023. Then what you are looking at is about an incremental charge in the ECL of about, £300 million. If you see it as worse than that then you are looking at our severe downside which I shan't go through but you can see the ECL consequences of that are around £2.3 billion, which is a lot of money, but in the context of capital generation of the business is a manageable amount of money.

So that is the second point and then the third and final point that I make is that having said all of that, when we look at the ECL, and we take PMAs, we have taken those PMAs, including within the £460 million that I mentioned earlier on, with an eye on the energy vulnerability of the particular client base that we have looked at. So for example we have put overlays on the agricultural sector. And the reason for that is because it is obviously an energy intensive sector both directly and also indirectly, in terms of the raw material that it is using. So I think it is a three part answer. One is we have embodied energy price increases in our economics and to the extent that the energy prices increase beyond our economics, guide you towards the downside and the severe downside for what that outlook might look like. The second is we have looked at the effect of energy price increases in the context of the ECL, including the £460 million. And then the third is we have taken particular PMAs with the respect to particular exposed sectors. Albeit they are obviously constrained by the economic scenarios that we are looking at, at any given time.

Alvaro Serrano
Thank you William.

William Chalmers
Thanks Alvaro.

Question 4 –Grace Dargan, Barclays Capital
Good afternoon William and thanks for hosting the round table. I just wanted to ask one please, whether the current economic environment alters your appetite for buy to let mortgages or impacts your plans around the Citra Living, build to rent proposition.

William Chalmers
Thanks Grace. I think when we look at the attractiveness of any given asset class, a couple of points might be worth making. First is that we adopt a very through the cycle lending approach. So our choice of sectors and lending approach that we adopt for each of them is very much done on a through the cycle basis. So we don't tend to go in and out of sectors at any given moment. Rather we take a stance on a sector that is intended to weather through economic developments as they might transpire.

The second as part of that really is that when we assess lending eligibility, when we assess the credit extension and put in further, more, affordability assessments, added buffers and so forth. We are specifically stressing for higher interest rates for example. We have added in affordability buffers for high cost of living adjustments for example. And so we are deliberately putting forward credit standards that are intended to look carefully at the economic developments affecting any given sector, including obviously buy to let. And how our credit standards might be able to support that client through tougher times, or put it the other way around, trying to make sure that the client is able to afford continued payments through what may be tougher times.

So the short answer on the buy to let sector is, again, we choose our sectors on a secular basis. We adopt a through the cycle lending approach and so although our risk metrics and our affordability constraints will vary with the economic cycle, our appetite for sectors as a strategic matter does not.

Second point on Citra. I think there was a period of time earlier on this year where competition for housing assets in the Citra space slowed us down. And so the strategic interest in Citra remains the same but we did not feel it appropriate to chase assets that we felt were ambitiously priced. It may be that the dislocation that we are seeing changes that dynamic and therefore allows us to potentially adapt the Citra strategy to that i.e. speed up if opportunities are available that we think are good value, in short. Again, it is a similar answer therefore which is to say our strategic interest weathers the storm. Our procedures, our appetite for debt at any given moment and the credit standards that we put in place or the pricing levels that we will accept, that is what will vary.

Grace Dargan
Very clear. Thank you.

William Chalmers
Thanks Grace.

Question 5 – Edward Firth, KBW
Afternoon William. Could I just bring you back to the interest rate question and at what point we start to stress out about ECLs because I get your answer of the house prices and unemployment that actually cause the crystallisation of losses. But I guess that they are also products of higher rates. They are not actually the drivers of higher rates. And I guess the ultimate source of the problem if you like seems to me likely to be higher rates. So I am just trying to think when you look at things like, I mean you know how you stretch your portfolio, you know what rate you stretch them to for example, what interest cover you have on your buy to let portfolio, all this sort of data that I guess we can't really see from outside. So I am just trying to get a sense, I mean clearly if rates go to 10 per cent then we have a problem, I mean I guess the economy has got a problem. So somewhere between 4 per cent which is predicted now and 10 per cent I guess is where we start to get into quite a lot of difficulty. So I guess my first question is could you help us a little bit just to give us some idea of where you think that current point is. That would be the first question.

And then the second one I guess related to that, you also talked about how as rates go up obviously the first few rate rises are hugely positive for the sector and you can keep a hold of most of it. I guess that also as rates go up you have mentioned how you still expect to see that smooth and the benefit to start to sort of diminish. Can you also give us some sort of sense then about where that crossover might be because it seems to me that there is a point at which higher rates become negative for the bank rather than positive. And I guess a lot of people are trying to think about where that might be. Sorry it is a very long question, I do apologise.

William Chalmers
Yeah thanks Ed. On the first point maybe a couple of observations beyond what I have already said. One is we do stress our lending for rates. I mean I think it is important to bear that in mind. So for example we are stressing mortgage affordability to 8.25 per cent right now - that is SVR plus 3 per cent is how you get there. And so we do stress our lending for rates. Those rates are significantly above current levels and hopefully that gives you some sense as to how we look at it. Likewise, when you look at the ECL you also have to pay attention I think to the quality of the lending that is underlying it. So for example we have a 40 per cent LTV in our mortgage portfolio right now. We have average earnings of our mortgage customers is about £75,000. There are reasons for thinking that the default if you like is likely to be low given that £75,000 point. But equally if there are defaults, don't forget the ECL is also a function of loss given default. And then look at things like collateral in the mortgage portfolio, I mentioned 90 per cent, or you can look at SME 90 per cent secured, or you could look at CRE 39 per cent LTV. So it is important to draw attention to the quality of the collateral that is underlying the loan before you get the ECL, it is not simply a function of probability of default.

The second point, Ed, on deposits. The overall transition in deposits and pass on deposits as I mentioned earlier on is starting to increase as rates go up and that is a very natural development. It is still, having said that, as you know significantly below our assumptions. Our assumptions are in fact ahead of 50 per cent as I said a couple of times at the HY and the pass on experience that we are seeing today as I said, it has been in the 20-30 per cent bracket, even the most recent one has been 40 per cent and therefore well below our planning assumptions. So I think there is still further to go as we look to the course of the remainder of this year.

The second point with respect to that is the transition, the switchover, that you mentioned also needs to bear in mind the fact that we will have next year a full year of some of the benefits that we have seen this year. So when you look at the interest rate, the interest income effect of these changes. Don't forget that this year we have only seen a partial experience of the effective base rate changes, of the effect of lower pass on in relation to those base rate changes. Of the effect of improving mix in the loan book for example. And all of these things next year come into the year in full. We start out the year with that enhanced margin as opposed to just having half the year effectively with that enhanced margin. So if you are looking at the income effect, look at it next year on a full year basis versus this year which is effectively a partial year basis. And bear in mind that, as said, those base rate changes, the lower pass on associated with them has a full year affect allied to, plus, whatever other base rate changes we might see next year which again will continue to compound that effect. Those are important drivers of our margin and income over the course of the next year. And then plus as you know we have a hedge that is probably maturing at £35 billion per year, on average. That gets re-priced into a higher rate environment too. So these are important income drivers which you know in the formulation of your question, which is at what point does the kind of income effect get overtaken by the ECL effect. Bear in mind that income effect is pretty strong is the point I am trying to make.

And then coming back to the final point I will make on the ECL effect, your turnover point, I don't think we are predicting that, we don't see it. But if you want to take a downside view versus where we were at HY, again I would steer you towards the downside of the economic scenarios, £4.8 billion or alternatively the severe downside of £6.8 billion that we disclosed at HY to give you some idea as to the kind of the effect that that might have upon the ECL. Those are of course effectively one-off type charges. So if you have to incur the extra £300 million, or the extra £2.3 billion in the severe downside, that is an IFRS 9 ongoing charge. The income effect that I mentioned earlier on, that is a recurring income.

Ed Firth
Yeah I see that. That is very helpful thank you. So just to clarify, when you say you stress to 8.25 per cent now, does that mean effectively that the bulk of your book was stressed to 6.5 per cent, something like that, is that I guess the number?

William Chalmers
Yeah I think that is a fair interpolation, you are looking at basically SVR plus 3 per cent and that is the heritage of the book. But don't forget that that which was stressed at lower rates is also that which is seasoned with a lower LTV and so bear in mind there are offsetting effects going on here.

Ed Firth
Perfect. Thanks a lot William.

William Chalmers
Thanks Ed.

Question 6 –Jason Napier, UBS London
Hi William, thanks for hosting the call. Two please, one is an extension of the previous conversation. If the curve is right and we do see policy rates of 4.4 per cent and SVR continues to go up in lock step with that I guess, I guess we are going to need to stress people to stress rates of 10 per cent or more. And I just wondered, not that I think that this creates LGD problems but I just wondered how that might impact gross levels of lending in the market whether you are able to re-finance customers where you save them money by taking them off SVR even if the affordability test becomes problematic is the first one. And then secondly, I wonder whether you would provide an update please on just how things like the hedge arrangement sort of operates. Is there a velocity of policy rate change that would be uncomfortable for the P&L? We have obviously seen a huge shift since you set up with two key results and I just wondered whether there is ever sort of a circumstance where the pace of curve shape changes is problematic for revenues even if it is just for a quarter or two. Thanks a lot.

William Chalmers
Thanks Jason. I might just ask you to elaborate a little bit on the second one to make sure I understood it. But just to address your first. First of all you are right in the sense that as rates rise we will be stressing the new lending to higher rates. We talked a lot about the mortgage rate in that example. But it is true for all of the other rates that we or the other books that we extend credit on. So that will start to grow as you say. I think at the same time in the context of what does that mean for new lending, it is probably fair to say that we are looking at a probably a much smaller mortgage market, you know probably some HPI pressure as well in the context of those higher rates. And so we would expect the new lending volumes to take account of that and probably be much more constrained in that part of environment.

Third point Jason as you know we have got a large fixed rate book and so it is right to say well a fair amount of that fixed rate book comes to maturity over the forecast period. And indeed that is the case and we will be looking to make sure that we put those borrowers onto a rate that is most efficient for them. And that is driven by two or three factors, most importantly it is driven by our obligations to the customers to get them into the right place and we will ensure that customers, just as we do today, are advised of all of their product alternatives. And that clearly becomes more acute in an environment where rates are very high today but you are looking at a much diminished forward curve. And so in short, when a customer comes to SVR and if we are looking at a curve that is inverted, well sorry, a curve that is lower on a two, five year basis, versus up front, will we advise them properly? Yes absolutely we will, but we do that today. You know it is our SVR customers get regular mailings on their product alternatives, they get encouraged to move to best value products. So we will do it as the right thing for the customer. We will as you suggest perhaps also have the side effect of producing better economics for us. I don't know whether that is the case or not, I have not really looked at it quite that way, but we will do it anyway just as we do it today. Does that answer your first question Jason before I move on?

Jason Napier
It does so I guess my summary if I have understood it correctly is we may see folks who might find it more difficult to leave their current bank. But there will be nothing in the affordability testing that might preclude you from allowing people who are already customers to refinance with you to get a better rate than SVR, even though the stressed rate that you ought to apply at origination might be problematic for some.

William Chalmers
Yeah I mean I think you know, this is, we are talking about the vast majority of our book which I would expect to be performing in these scenarios and we will deal with them in these scenarios pretty much along the same lines as today albeit as said some of the issues may be higher profile. I think then Jason if there are customers that are in financial difficulty in any sense then we will deal with them again similar to the way we deal with them today in terms of our customers in financial difficulty type arrangements which often results in rescheduled payments if that is necessary or you know other similar types of metrics. So those are the facing into credit issues will be dealt with in a way that it is sympathetic to the circumstances and ensures that our payments profiles are affordable from their point of view. Thematically that is exactly what we do today. We are, we have been for some time actually, preparing for a tougher economic environment to ensure that we are ready for increased volumes of customers in that spirit, but we will deal with them in the appropriate way and ensure that you know we are doing the right thing as far as we can.

Jason Napier
Thank you. And then the second question just in terms of are there any sets of circumstances on policy rates where if it goes up really quickly, or a lot quicker than markets expected earlier in the year, where that causes discomfort for the outlook for NII?

William Chalmers
Okay got it. I will answer that and I have also got Cecile Hillary in the room here with me who I will ask to add to the gap that I will inevitably have in my answer. A couple of points that I would highlight. One is as you know we have significant maturities of the structural hedge in any given period. At HY we had about £13 billion for H2. Next year I think it's about £35 billion and then goes up quite sharply thereafter. So that gives us a lot of flexibility to reinvest the hedge at whatever the prevailing rates might be at that point. Now having said that there is another side to this which is not capital related but is cosmetically related which is around the cashflow hedge reserve. And so to the extent that we have an invested structural hedge as rates rise we have an effect on the cashflow hedge reserve which in turn reduces the central net asset value of the bank and that is the inverse effect. Now that is not in capital as you know we hedge in liquid derivatives, taken through the consolidated accounts. But it does not drive or effect capital as it does with some other banks. And therefore that is the flip side of it and that does have an effect but only on tangible net asset value. Ironically enough it also enhances our RoE as you will have seen I am sure in your numbers. So you get slightly lower TNAV but you also get a slightly higher RoE. I think that is, I will probably stop there, Cecile is there anything that you would add?

Cecile Hillary
I am not sure I would add very much but perhaps say in addition to what obviously William was saying, there is obviously the maturities rolling off. Obviously William mentioned the £35 billion in which we see corresponds to, you know that is that is about £250 billion hedged you know with a sort of three-and-a-half year, or there abouts, average life right so we can obviously see how much rolls off every year. Every year indeed in addition we have got still a significant buffer that we are sitting on with deposits that are exposed to and create some additional positive NII sensitivity. So I would point to all of that. Now obviously all of that is going to depend on the deposit pass through so that is clearly as William said earlier the pass through will tend to increase as rates increase as well. But nonetheless we are still at the rate of pass through that is quite good. So really, I mean it just adds positive tailwind in terms of NII activities.

Jason Napier
Thanks very much.

William Chalmers
Thanks Jason.

Question 7 – Andrew Coombs, Citi
Good afternoon, a couple of questions please. The first is more broadly on bank reserve tiering. If I look at your level one profile at the moment I think you have got about £80 billion in bank reserves, and £60 billion in gilt and agency bonds. On the assumption that some form of reserve tiering were to be introduced in part to encourage you to invest in the glut of gilts that is likely to come our way in the coming couple of years, can you just remind us how that potential switch would impact on LCR and NSFR? So that would be the first question.

Second question is contingent liabilities. So if in order to support these fiscal stimulus measures rather than gilt issuance to get more contingent liabilities in the form of Government guaranteed loans to suppliers. Presumably you would act as an intermediary in this. So in that event and given the read across of what we saw during the pandemic, any thoughts on how that might play out both in terms of RWA addition, loan book addition, so forth and so forth? Thank you.

William Chalmers
Thanks for that Andrew. A couple of thoughts maybe. Again on the first, I will make some comments and then Cecile may want to add as well. And second, fiscal stimulus and the effect of loans. Absolutely fine, happy to comment on that.

In terms of the reserve numbers your numbers are about right. I think we disclosed in our HY results that we have got about £78 billion in cash and central bank reserves. And then we have got about another £63 billion in basically Government bonds. So those numbers that you quoted are right. In the event that we saw some sort of tiering and again it is, at the risk of repetition, worth me stressing that we know as much about this as you do. That is to say we are not having any conversations or having indication of it. But in the event that we did we would look to potentially replace or rather redistribute some of those reserves from where they are today to more yielding activities. And so you will be aware at the moment, we have got an LCR ratio which is around 150 per cent or so. And that in turn is in excess of the requirements that we typically choose to operate at. It is a function of the environment that we have been in for some time now actually and obviously associated with the concept of easing and all of that sort of thing. And so liquidity of the bank has been high for a while and it continues to be high. And so step one in a sense is trying to figure out what should our liquid assets be so that we operate still within regulatory defined ratios. Clearly we need to do that. But on the other hand we don’t have excess liquidity in the way that we have done over the course of the last really two or three years I guess, maybe even longer. So you rationalise step one. And then step two you also think very carefully about what actually qualifies for the LCR in that context. And as said there are a number of ways of meeting LCR requirements which do not necessarily require LCR deployed in quite the way that we do today. And so both of those two measures I think would offset tiering. Depending on the severity of tiering it maybe that we can offset the vast majority of whatever that tiering will be. If it is really severe, it is obviously going to be tough because at the end of the day we have liquid asset requirements. And then net stable funding ratio, as you know net stable funding ratio is in a process of evolution right now in terms of its binding nature. Overall I think I would just repeat more or less the comments for NSFR as I just did for LCR. It is the same dynamic really that applies as to how we would meet that constraint. But again bear in mind that constraint is earlier in its application process.

Before going on to your second question I am going to pause there and ask if Cecile would add anything?

Cecile Hillary
Perhaps just adding a few additional things. Indeed, we tend to focus as you know as respect to our liquid asset portfolio on level one assets you know versus other bank peers who may add more, a little, to assets. Obviously our liquidity position is very very strong. In terms of LCR and NSFR as William mentioned we have got plenty of room beyond regulatory requirements. And I think in terms re-deployment obviously we would look in that situation at details and would look at other potential assets depending on where we feel the value is. But again overall it is really quite speculative. And finally what I would say is yes of course we need to think about LCR, we need to think about NSFR. But obviously we would look at other metrics, right, for instance if we were to redeploy we would need to see the impact on a leverage balance sheet, there are a number of metrics that we would look at, it is not as simple as saying we would re-deploy, reserves into gilts for instance.

William Chalmers
Thanks Cecile. Andrew on your second question, fiscal stimulus and how it might be enacted. We obviously wait with interest to see what the Government is going to do. We are very aware of any potential discrepancy between treatment of retail and treatment of business and we hope that whatever the solution will be will ensure that there is appropriate support however defined to all areas of the economy encompassing both retail and business. It is possible that in the context of some form of Government guaranteed loans programme if that is what they choose to do that we will act as a distribution agent in that

respect. Again we don't have any notice of that, we don't have any information at this point that you don't have. And so unclear what they will do. But in the event they try to replicate what happened with Covid i.e. bounce back loans and CBILs, then there is a potential role for us to play for sure. In that context as you know we had fully guaranteed loans in the context of BBLs and we granted about £9.5 billion of those. And we had partially significantly (partially not completely) guaranteed loans in the context of CBILs. And the risk rated asset treatment very much mirrored that treatment. So BBLs we had zero risk rated assets for, and CBILs we had proportional risk rated asset treatment for. And that would be the capital consequences of whatever lending that we might be asked to undertake in that respect. If we are asked to undertake it we will obviously enter into it you know in the full spirit of the exercise just as we did with the Covid exercise. And you know seek to play our part in ensuring recovery for the clients that we serve and the economy as a whole. But as I said the Government guarantee does make a difference to risk rated asset and therefore the capital treatment.

Andrew Coombs
Thank you both.

William Chalmers
Thanks Andrew.

Question 8 – Raul Sinha, JP Morgan
Afternoon William. Just a follow-up on this whole discussion around asset quality. I have been looking at your historical stress test results and especially I think there was one in 2019 where there was an interest rate hike assumption built into the stress test. And I just wanted to ask you a couple of questions sort of comparing your stress test performance to clearly what your IFRS9 and much more updated IFRS9 downside scenario shows. I guess the question is are the assumptions in the way these stress test losses are formed consistent with the way you approach your sensitivity that you display for IFRS9? And also related to that there are parts of your book that stress particularly badly in the PRA stress test. I wonder whether you would guide us to think differently about them in any upcoming stress test or in your IFRS sensitivity just given the nature of how historical stress tests have been built up?

William Chalmers
Thanks for that question Raul. Perhaps a couple of points to make and you can tell me if this answers your question appropriately. But in essence 2021 was a very harsh UK centric stress which as you know we passed without converting AT1. It is also worth comparing and contrasting that against the later stress which in turn showed a significant improvement on drawdown. What is the likely effect now versus then? I think you have to take into account a period of significant house price inflation which will change the performance of that particular asset class in the context of the stress versus what it might have been then. You have to take into account the duration of the stress and how long it lasts. And that in turn has an impact upon what you might get in terms of IFRS9 front loaded charges versus what you might get in terms of ultimate loss crystallisation or alternatively in terms of RWA build-ups. So I think there is a couple of differences that are worth highlighting Raul in the context of asset price developments that have taken place since the 2019 stress. In the context of the characteristics of the stress that is being applied. And then if you like address that, think about that. I guess that in that context and given those comments Raul I would draw your attention to the economic scenarios that we put forward because that is a more mark to market view as to how we would see the book develop based upon the current characteristics of that book.

One other point on ACS and then one point on your question around particular areas of the book. We don't yet know what the ACS assumptions are going to be for this round. We look forward to receiving those clearly, in the coming weeks I guess it is. And then we will be working through those. I probably shouldn't comment further on the ACS safe to say that it would surprise me if it was the same as the set of assumptions that we used in 2019. And what might be different that is particularly important, it is of course interest rates and inflation. And that in turn gives a massively different income picture to what we saw in 2019 which is a low rate scenario. So I don't know what the assumptions will be for the ACS that is coming up but I suspect that there will be one very big difference which is around the inflationary stroke interest rate environment which in turn drives a different income picture versus what we saw during the 2021 period.

The second point that you asked, and this is around the asset classes that draw capital in the context of the stress. I guess the one that I would highlight there, hopefully it is much the same as you is the capital that is consumed by what we call our heritage book which is effectively the mortgage book that was written largely by HBOS in the period before the takeover. That consumes significant ACS losses and I am not sure whether we disclosed this number or not but it is around the £40 billion mark or thereabouts in terms of size. A couple of points there. We see that book now as having experienced significant seasoning i.e. over ten years HPI growth with people who have been consistently paying mortgage balances day in and day out. In reflection of that the average LTV for that heritage book is 35 per cent, 34.9 per cent to be precise. The average loan for that heritage book is £110,000. So it is pretty spread out between a large number of borrowers.

And then finally if you look at the best way of sampling the experience of that heritage book, when we had the pandemic it was not overly representative i.e. disproportionally represented in payments holidays. And so the performance of that book during the most recent exercise that we have evidence of was not significantly different to the rest of the book. So I guess it is, this is the book that I think when we look at the ACS losses draws a significant amount of ACS capital. But when we look at its actual performance and when we look at the characteristics of the debt associated with it we feel it is in pretty good shape. I am happy to talk about other books but that is the one that I think you are referring to isn't it?

Raul Sinha
Yeah thank you. I mean that is really helpful. I might follow-up offline but I guess there is also this question about how the BBLs and CBILs part of the portfolio would work and whether or not they would be treated, you know the way that they would actually behave in the ACS scenario?

William Chalmers
Well it is a fair point. I will give you an answer to that, but please do feel free to follow up with the team obviously. The BBLs as you know is a fully Government guarantee lending and so we expect to be reimbursed for whatever loss the BBLs might experience. The piece that I am focused on is to what extent if any there is any link or contagion risk between BBLs on the one hand and underlying borrowing from the same borrower on the other hand. And when we look at the provisioning, the appropriate provisioning for that borrower who has taken out a loan with us, straight forward loan with us, BBL with us, we are taking account of the fact that that borrower has an overlap and therefore the provision that we are applying against the regular loan takes into account the performance and the exposure on the BBL. And to that extent you know it may be that this is revealing a part of customer who is more in need of financial assistance than others but to the extent that it impacts our ECL do bear in mind that we are looking at the provisioning for that regular loan that is connected to a BBL taking into account the fact that customer has a BBL and taking into account the experience that we see on that BBL.

Raul Sinha
Thank you very much.

William Chalmers
Thanks Raul

Question 9 – Guy Stebbings, BNP Exane
Hi William thanks for hosting the call. Two questions. The first one is on deposit answer in your reference to being within that 20 to 30 per cent industry range for deposit pass through thus far. Can I just clarify that reference to your entire deposit book i.e. include deposits that would be incorporated within the structural hedge or are you explicitly referencing un-hedged deposits there? And then the second question was just on the structural hedge and you will have obviously done a lot of work around the behaviour of those deposits and got comfortable that they are rate insensitive. I just wondered is that analysis struck in reference to any base rate move and at some point could you see a risk around a portion of that book not actually being rate insensitive and if that is the case where might that level sit? Thank you.

William Chalmers
Thanks Guy. Two questions there. One is in terms of the deposit pass through, as said we have had about a 165 basis points of base rate rises. We have passed on to the depositors across the board, across the variable rate book, the 20-30 per cent mark that I mentioned earlier on. So the answer to your question in short is that is a comment for the variable rate book in terms of the pass on. We hedge a good part of that variable rate book but not all of it. So we have never actually disclosed a precise number but as I say it is a good part of it but it isn't all of it.

In terms of the structural hedge rate sensitivity, it is a question that we obviously keep a very close eye on. It is worth just bearing in mind a couple of figures and one is as you know we have got a structural hedge position right now of £250 billion which has increased since 2019 by about £65 billion. Now since that time we have had deposit increases of c £70 billion, just shy of that actually, about £67 billion. But at the same time we have also had deposit eligibility principally within the commercial book increased by £16 billion. And we have also had amounts that were previously in the buffer because we weren't sure about their behaviour, showed persistence looking forward. And that is about £10 billion. So if you net each of those two off we have actually only invested about £40 billion of the £67 billion in increased deposits that we have seen. The rest of the £65 billion increase in the hedge has been improved deposit eligibility from deposits we already had because we have managed the characteristics of those deposits to make them hedge eligible. And experience through time if you like of the previous buffer.

So today we sit on a hedge that is £250 billion but we have those characteristics of the increase in the hedge. We also have maturities H2 22 I said it was about £13 billion. 2023 is about £35 billion and then the numbers get larger thereafter. And finally on the hedge we have a buffer right now of about £29 billion. So if deposit behaviour is going to change materially we have a buffer of £29 billion, to be precise, to cope with that change. That is such a substantial part of a) our deposits and b) UK GDP that frankly depositor behaviour is hard to imagine that we really get into any type of challenging situation. But to be sure, to be clear we look at this very carefully and if we ever think that depositor behaviour is changing then we will manage clearly the buffer and any income and maturities appropriately in that context. So we are not trying to be complacent about it, but we have deliberately built up the buffer to £30 billion, it is supplemented by those maturities and that in turn, the buffer point in particular, is because we have held back investing a lot of the deposit growth that we have seen. Guy is that okay as an answer?

Guy Stebbings
Yes perfect, thank you.

William Chalmers
Thanks very much indeed. I am afraid we will have to call time on the session today. Not least because I have a couple of non-executive directors waiting for me on another question. So I just want to thank everybody on the line for taking the time to dial in. Hopefully we have got to a number of the questions. The team is always available as am I for any questions that you may have beyond this conversation. And again thanks a lot for taking the time this afternoon.

END

FORWARD LOOKING STATEMENTS

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