LLOYDS BANKING GROUP PLC – Q1 2022 INTERIM MANAGEMENT STATEMENT – PRESENTATION TRANSCRIPT
(amended in places to improve readability only)

Wednesday 27 April 2022 – 9.30am

LBG:
William Chalmers, Chief Financial Officer

William Chalmers
Good morning, everybody. Thank you for joining our Q1 interim management call. As usual, I will run through the Group's financial performance in the first quarter of 2022, before we then open the line for Q&A.

It is only nine weeks since Charlie and I outlined the Group's new strategy alongside the full year results, so I do not intend to go through our strategic plans again today. I will none the less provide comments on this for the half year. Suffice to say, the Group has embarked upon implementation of the plans we set out in February. Indeed, you may have seen the recent announcement on our new management structure, which is aligned with the new strategy and positions the Group for delivery.

Now, let me turn to the results presentation, starting with an overview of the financials on slide 2. The Group delivered a solid financial performance in Q1. Net income of £4.1 billion is up 12 per cent on the prior year, supported by a stronger net interest margin of 268 basis points, other income of £1.3 billion and a continued low operating lease depreciation charge.

We remain committed to efficiency and retaining our market-leading cost position. Operating costs of £2.1 billion are up 3 per cent year-on-year, reflecting stable BAU costs and planned higher investment. We remain on track for the circa £8.8 billion operating cost guidance for the full year.

Asset quality remains strong. The £177 million net impairment charge reflects a low incurred charge with new to arrears remaining very benign and below pre pandemic levels. It also reflects our updated economic outlook, which I will talk more about later on in the presentation.

Given this solid performance, statutory profit after tax is £1.2 billion and the return on tangible equity is 10.8 per cent. Underlying this outcome, we have seen continued franchise and balance sheet growth. Capital build of 50 basis points in the quarter, after the 230 basis points of regulatory headwinds on the first of January, was strong. This has enabled the Group to make significant accelerated contributions to the defined benefit pension schemes. As of Q1, we made the full £800 million annual fixed deficit contribution, plus around half of the expected variable contributions relating to our year end planned distributions.

Finally, risk-weighted assets closed the quarter at £210 billion, following the regulatory inflation of £16 billion, which we outlined at the full year.

Moving on to slide 3 and the continued recovery in customer activity and franchise growth seen in Q1. We continue to see good levels of activity in the UK mortgage market. Balances were up £1.2billion in the quarter, given continued open mortgage book growth of £1.7 billion.

Credit card balances were flat in the quarter. That is a reasonable performance given the normal seasonal repayments that we see in Q1. Added to this we are seeing improving travel spend given lifting restrictions, which is an important component as you know of overall card spend.

Elsewhere in consumer finance, Motor Finance is up £0.1 billion in the context of supply chain issues across the motor industry. Commercial Banking balances meanwhile are up £2.6 billion, led by the growth of £2.9 billion in Corporate and Institutional, particularly higher financial institutions balances. Taken together, average interest-earning assets at £448 billion are up £8.6 billion on prior year. AIEAs are down £1.4 billion on Q4, driven by lower trade and average term lending balances in Commercial Banking. However, for 2022 as a whole, we continue to expect low single-digit percentage growth in AIEAs.

Now looking briefly at the other side of the balance sheet. We have continued to see deposit growth in Q1. Retail deposits are up £2.5 billion, reflecting resilient customer inflows across current accounts and relationship savings products. This further highlights the strength of our customer franchise. Commercial deposits are up £2.8 billion, driven by higher balances from SMEs and Corporate and Institutional clients.

I will now look at the Group's strong revenue performance on slide 4. Net interest income of £2.9 billion is up 10 per cent year-on-year and up 2 per cent in the quarter. This was significantly driven by the stronger net interest margin of 268 basis points on average interest-earning assets of £448 billion.

The Q1 margin is up 19 basis points on Q1 2021 and up 11 basis points on Q4. This is the result of base rate changes, increased deposit volumes and benefits from the structural hedge, more than offsetting the dilutive impact of mortgage margins. As mentioned, we continue to see a competitive mortgage market with average completion margins in Q1 around 85 basis points. Application margins are below this level, in the context of both pricing and swaps continuing to move upwards. We will continue to monitor closely how this develops, recognising we probably need a period of swap stability to see where margins ultimately settle.

Turning to the hedge. The structural hedge now has a nominal balance of £245 billion. We have approved capacity of £250 billion, up £10 billion in the quarter, including a little more of the substantial deposit growth experienced through the pandemic. We continue to be cautious on hedge eligibility, with buffers of roughly three times pre-pandemic levels.

In this context, gross income from hedge balances was £0.6 billion in the quarter. Given rising swap rates, we continue to expect 2022 hedge income to be higher than 2021 and then to increase modestly again in 2023 and '24. We remain positively exposed to rising interest rates. We currently expect a 25 basis point parallel shift in the yield curve and associated base rate rise, to benefit interest income by around £175 million in year 1. As you know, this is illustrative and based on the same assumptions as we have outlined previously, including the 50 per cent pass-through. Clearly in practice, the pass-through could differ from this assumption, as indeed we saw in Q1.

The Group's interest rate sensitivity is lower than reported at the full year given the increase in the size of the hedge. Higher rates over the last few weeks and a larger hedge means that we have locked-in more interest income through the P&L, rather than reporting a theoretical sensitivity. It is also worth noting that the sensitivity, as always, does not consider potential asset spread compression, particularly in mortgages as a result of swap movements, again as we have seen during the first quarter.

In practice, what we are seeing is base rate changes benefit income today and this is expected to persist through 2022, providing a net tailwind to the margin. The impact of mortgage repricing, if spreads remain low, will continue to build into the margin in the second half and indeed over the longer-term. For 2022, the base rate changes we have seen so far this year and the very significant interest rate moves in the market in recent weeks, combined with our new year end base rate assumptions, are resulting in an improved interest income outlook. We therefore now expect the Group margin to be above 270 basis points for 2022.

Now looking briefly at other income. OOI continues to show signs of recovery. £1.26 billion in the quarter is up 11 per cent on prior year and in line with the last three quarters. As mentioned, we are seeing improving activity levels in Retail and Insurance, while Markets performance has also improved in Q1 over Q4. We saw an adverse impact of around £30 million in the quarter relating to the winter storms, although this was offset by a positive insurance methodology change. If you remove these items, the underlying run rate for the quarter was just over £1.2 billion.

Operating lease depreciation at £94 million in the quarter remains low in the context of the reduced Lex fleet size and continuing strength of used car prices.

Now let me turn to slide 5 and the Group's continued focus on efficiency. Operating costs of £2.1 billion are up 3 per cent on prior year. As mentioned, this includes stable BAU costs combined with planned higher investment. We outlined the Group's new cost reporting basis at the full year. The restructuring costs and fraud charges, that are now included within BAU operating costs, are broadly in line with the prior year charges.

Our cost:income ratio of 52.3 per cent remains market leading. As you can see on the slide, the cost:income ratio, excluding remediation, is 51 percent, consistent with previous quarters. The remediation charge of £52 million in Q1 reflects a continuation of existing programmes and no further charge in respect of HBOS Reading. The Q1 charge is in line with our expectation of an ongoing cost of £200 to £300 million per year.

In sum, we are maintaining our focus on efficiency and our market-leading cost position, even after increased investment. We remain on track for the circa £8.8 billion operating cost guidance for 2022.

Turning to slide 6 and the Group's asset quality. Asset quality remains strong and new to arrears remain very benign, with underlying charges below pre-pandemic levels. The net impairment charge of £177 million for the first quarter reflects an underlying charge of £150 million, plus £27 million in respect of our updated economic scenarios. We revised our base case economic assumptions at the quarter end. They now include a slightly weaker GDP forecast, but given performance in the year to date, slightly stronger house price and unemployment outturns. Alongside this, we now also expect higher inflation. For 2022, we forecast CPI inflation of 7.5 per cent, peaking in Q2, with 4.3 per cent thereafter in 2023.

We are focused on the potential impact of higher inflation on our customers and potential risks to asset quality. Our low-risk model means we have limited direct exposure to customer segments which are most likely to experience near-term payment difficulties from cost-of-living pressures. However, we are proactively contacting customers where we feel they may need assistance and will continue to help with financial health checks and other support measures.

While discussing asset quality, it is worth noting that we have no direct exposure to Russia or Ukraine. We are actively investigating and monitoring any indirect exposures and have not yet found anything of significant concern. Our clear UK-focused business model is helpful in this regard.

Overall, absent a material change, the main effects on us of the current Ukraine crisis and attendant inflationary impact, are likely to be second and third order, for example on overall levels of economic activity. We expect those to be captured by our macroeconomic forecasts, but of course we remain vigilant. Based on this outlook, the stock of ECLs remains stable at £4.5 billion at the end of Q1. This remains around £0.3 billion higher than at the end of 2019, before the onset of the pandemic.

Within that ECL, we continue to hold just under £800 million of COVID-related management judgements, including the central adjustment. We have also now added a further judgemental ECL provision of about £100 million to reflect potential affordability risks for our lower income customers. Touching briefly on our IFRS 9 staging. As we have discussed before, in Q1 we updated our models to reflect CRD IV regulatory requirements. Notably this includes changing the definition of default for mortgages from 180 to 90 days and updating our approach to past-term interest only mortgages. Together this has resulted in an increase in mortgage assets in Stage 2 and Stage 3. This change is presentational, it does not change the economics and has an immaterial impact on ECLs. And indeed excluding this regulatory change, the underlying movement in mortgage asset staging in the quarter has actually seen further improvements.

In summary and looking forward, given our performance to date and macroeconomic scenarios, we continue to expect the net asset quality ratio to be around 20 basis points for 2022.

Moving on to look below the line on slide 7. Following the change in cost reporting that we outlined at the full year, there is now very little difference between underlying and statutory profit. As you can see, restructuring costs of £24 million reflect only the remaining M&A and integration-related costs.

The volatility line shows a charge of £138 million and includes negative insurance and banking volatility, in addition to the usual fair value unwind and amortisation of purchased intangibles. And after these items, statutory profit before tax of £1.6 billion and profit after tax of £1.2 billion both represent a solid financial performance. The return on tangible equity of 10.8 per cent in the quarter, above our cost of capital, reflects this performance. Based largely upon the stronger income outlook that I outlined earlier, we now expect the RoTE for 2022 to be greater than 11 per cent.

Tangible net assets per share were 56.5 pence for Q1, up 4.1 pence on prior year but down 1 pence on Q4. The quarter-on-quarter movement largely reflects strength in income contribution, offset by movements in the cash flow hedge reserve, given how rates moved in the quarter.

Looking forward, you should remember the 2021 final dividend will come out of TNAV in Q2, while the buyback impacts as the programme is conducted through the year.

I will now turn to slide 8 and consider the Group's capital position. Risk-weighted assets of £210 billion are up £14 billion in the quarter, but down £2 billion excluding the regulatory inflation of the first of January that we set out in the full year results. Lending growth has been offset by optimisation and we have seen limited impact from credit migration given our strong portfolio.

Strong business-led contributions, augmented by effective RWA management, have supported strong capital build of 50 basis points in the quarter and a closing CET1 ratio of 14.2 per cent, both after the headwinds on the first of January.

Importantly and as previously mentioned, the healthy capital build has enabled the Group to make significant accelerated pension contributions. We have already made the full annual £800 million fixed contribution and this is included in the 50 basis points build. In addition, we have made around half of the variable contributions relating to our planned year end 2021 distributions, equivalent to £500 million. This is reflected in our 14.2 per cent CET1 quarter end position. This is an efficient use of capital and means the Group will have greater free capital through the rest of 2022.

In line with the guidance given previously, we continue to expect 2022 closing RWAs to be around £210 billion. This is driven by expected balance sheet growth, offset by optimisation activity through the rest of 2022.

And so based on our performance to date, our business model and the outlook, we expect capital build to continue to be strong though the rest of this year.

Finally turning to slide 9. In summary, the Group has delivered a solid financial performance in Q1, with strong revenue growth supported by an increased margin and continued recovery in customer activity. At the same time, we have maintained our focus on costs. While asset quality remains robust.

Capital build of 50 basis points in the quarter supports the Group's strong capital position and has enabled significant pension contributions.

As mentioned, uncertainties persist in the current environment, most notably concerning the potential impact of inflation on our customers. In this context, we will provide effective support for our customers, wherever we can. The Group's business model is resilient. Together with our new strategy, it positions the organisation well.

This confidence is reflected in our updated guidance for 2022. As you have heard, we now expect the net interest margin to be greater than 270 basis points and the return on tangible equity to be greater than 11 per cent. All other guidance statements, including those for 2022 and the longer term, are reaffirmed.

Outside of the financials and as mentioned at the start of the call, the Group has recently implemented a new management structure. This is fully aligned with our new strategy and helps position the Group to deliver higher, more sustainable returns and capital generation.

That concludes my remarks for this morning. Thank you very much for listening. Let me now turn the call to Q&A.

Question and Answer Session

Question 1 – Omar Keenan, Credit Suisse
Good morning everybody, thank you for taking the questions. I had some questions on net interest income please and I wanted to ask on the revised NIM guidance, which is now above 270 basis points. I understand that's the floor, rather than the target, but I wanted to understand what the minimum assumption changes that were there so we can make our judgements of how far above 270bps it will be. Presumably at least it is the deposit beta experience from the December hike and maybe including an extra Bank of England rate hike. But if you can clarify what those minimum conditions are that will be very helpful.

And secondly on the structural hedge, I can see that the duration has shortened a bit from three and a half years to between three and three point five. I guess the shape of the yield curve lets you do that without giving up any yield. What are the various debates that you are having at the moment in terms of how to position the structural hedge given what is going on in the fixed income market? It looks like you think it is worth shortening a bit and say increasing your year two to four rate sensitivity if you think the bias to yield is ultimately higher. Thank you.

William Chalmers
Thank you for the questions Omar. Just to deal with each of them sequentially. In terms of the guidance on net interest margin we have increased it from greater than 260 to greater than 270. In the context of significantly increasing rates and of course the effective bank base rate changes to date, applied to substantially increased deposit volumes over the course of the pandemic including some of the growth we have seen in the last quarter.

Now, as you point out, the language is greater than 270 and so in that sense it's a floor, but what are we looking for in terms of the basis in which we have undertaken those judgements. First of all I will draw your attention to our slightly revised economics forecast so we have one more base rate rise in the context of that. That is a base rate rise that we expect to take place before the end of this year. One in May and one in the later part of the year takes the base rate to 1.25 per cent. We then see one further base rate rise before flattening out thereafter.

The second is the rise in interest rates generally that we have seen over the course of this quarter. So since the 24th February spots on year is up around 50 per cent or so, term rates are up around 35 per cent or so and so that has been a factor too.

And finally the third area you might look at is around the deposit beta assumptions we have made, which are very much in line with the guidance we have given you before, which is that as we progress into the rising interest rate environment, the rising base rate associated with that, then I think we will see the pass-on assumptions start to converge towards the 50 per cent that we model on, on a continuing basis. And so, those are the type of judgements that we put into our expectations around the margin. There are clearly some moving pieces in there, what will happen to interest rates for example, how will the bank base rate environment play out for example. And indeed ultimately what will the deposit beta be for example, are three points in question. But that is the basis on which we have performed the interest margin guidance.

The structural hedge. The structural hedge as you know is managed both for continuity and stability in earnings and also for shareholder value. We manage the hedge dynamically. We are very much aware of and debating interest rate movements as we see them on an ongoing basis. Now underneath that, this is about hedging interest rate risk and therefore contributing earning stability to the P&L. And that is the objective and that is why we generally manage around the weighted-average life that we manage to, we don't tend to deviate too much from it.

As we look forward, we will debate where rates are today, we will look at obviously the inflationary outlook and how we expect both the Bank of England and the markets to adjust that over time, and we will deploy the hedge accordingly. But that will all be within pretty tight risk management standards that in the end are about ensuring earning stability in the context of shareholder value.

Omar Keenan
That is wonderful. Can I just ask a quick follow-up question on the deposit beta. At what point are you assuming that they converge to the 50 per cent? I guess the deposit beta experience from the December, February and maybe March rate hike you factored?

William Chalmers
We won't disclose precise details on that for obvious commercial reasons, but generally speaking I think it is fair to say that in the context of the initial base rate rises the liability margin has recovered somewhat and therefore the deposit beta has been lower than the 50 per cent we would typically describe it as. Looking forward, I suspect it will gradually converge to that level as interest rates increase, but we are not disclosing more than that in terms of the path we will follow.

Omar Keenan
Okay thank you very much.

Question 2 – Rohith Chandra-Rajan, Bank of America
Thank you very much, good morning. Sorry I am going to stay on the margin. Thank you for the comments on the liability side, that is certainly very helpful. You mentioned earlier that application spreads on mortgages were below the 85 basis points completion spread that you saw in Q1. I guess when we look across the market you see lenders continuing to raise mortgage rates but really not keeping pace with the moving swap rates. I'm just wondering how far below the 85 basis points current application spreads are, and do you still think the 75 to 100 basis points mortgage spread guidance that you gave at the full year results is reasonable? Particularly for this year and then also over the period of the plan? That would be one question.

Then just picking on margins, on the consumer credit side of the business. Are you still confident in the recovery in demand for consumer credit given the concerns around inflation that you flagged. Then I have another one on capital please.

William Chalmers
Thank you Rohith. On your first question on mortgage pricing, which is obviously a factor in the overall net interest margin as well as you point out. A couple of points there, first of all completion margins, as said, 85 basis points during the quarter, consistent I think with what we said February 24th. But also, as you say, application margins, as per my script earlier on, have been below that over the course of the quarter and that of course will feed through into our completion margins that we talk about in Q2.

In terms of your question around how we feel about the planning assumption of 75 to 100 basis points, we don't generally mark our plans, our three-year, five-year plans, to market every quarter. But I suppose you have seen two divergences over the course of this quarter. One is interest rates, clearly significantly above our plan, which is a net positive from an earnings point of view.

And the other is application margins, which have probably been a touch below our plans of 75 to 100 actually over the course of the quarter, which is a net negative. Now you add those two together and it is a net positive, to our expectations, versus where they were on February 24th. So the net effect of interest rates versus mortgage margins, both today and also as we project forward into 2023 and 2024, is a net positive versus where we were on February 24th.

It is also worth saying that even if mortgage completion margins ultimately slip to the lower levels of our planning assumptions, even a touch below, it is a pretty attractive business, from an economic return point of view. So we consider that and we bear that in mind as we move forward.

Consumer credit. We have seen increases in expenditure within consumer credit over the course of the quarter. So if you look at Q1 credit card retail spend now versus what it was in Q1 of 2019, it is up 7 per cent and that trajectory has been gradually improving through the three months. So for example March 2022 credit card spend is up 13 per cent versus where it was in March 2019. Aligned to that, we also see travel spend recovering quite fast, I think I mentioned it in my comments. And that is responsible for around a third of our overall credit card expenditures. To be clear, there is a balance in there, which is typically more weighted towards transactors today versus revolvers and that needs to be accounted for in terms of the pace at which balances might expand within consumer credit. But those spending patterns are broadly supportive of consumer credit gradually, and I would make the point gradually, expanding more or less in line with our expectations. Not hugely different to where we were on February 24th.

Rohith Chandra-Rajan
Thank you and sorry, just on the mortgage spread, would you be able to comment on where the application spreads are currently?

William Chalmers
No, I don't typically comment on the application margins, they vary quite a lot in any period of time. What I would say around the margin question and mortgages in general, is that we have seen a period of rapidly rising swap rates and as you pointed out in your question, we have also seen alongside that rising pricing. Now, a lot of people pre-hedge and therefore pricing generally will lag swap rates, and that I think is what we have seen in Q1. I think what we have to see to get a good impression of what the overall margin is going to be on a stable look forward basis, is a period of swap stability, and at that point pricing can catch up, and at that point you will get a sense as to what the true mortgage margin is. Indeed, in the context of our 75 to 100 basis points planning assumption for 2024, I think we feel comfortable with that. But let's wait for that period of swaps stability, let's see how prices react and let's see where ultimately the mortgage margin settles as a consequence of that.

Rohith Chandra-Rajan
Okay thank you very much. Then I just had a quick one on capital please, particularly around the pension contributions. So you mentioned that you've taken all of the fixed contribution and half of the variable. So in terms of how we think about the phasing of the variable contribution, the Q4 and Q2 distributions, the contributions related to those, shall we think that they are evenly split over the subsequent two quarters?

William Chalmers
Thanks Rohith. First of all in terms of the fixed contribution. As you know the fixed contribution is around £800 million per year. We have taken all of that in the context of our Q1 capital numbers. In total that is about 31 basis points of capital consumed by that, which is before you get to the 50 basis points capital generation. The accelerated component of that, is obviously three-quarters, so around 23 basis points of capital is consumed by that accelerated proportion of the fixed pension contributions which gives you some idea around the underlying capital generation of the business.

And for the phasing of the variable, there is no pre-determined schedule for that, it is reasonable to think about it as spread through the course of the year. We have taken a view that we had, frankly, strong capital generation in Q1 and therefore we felt it appropriate to accelerate variable contributions ahead of what we might otherwise do. And that is what we have done. We will see how capital generation fares for the remainder of the year, which as I said, we expect to be strong. But in that context, we will look to get to get the variable contributions behind us, probably reasonably promptly. I think overall there is no particular schedule for that variable contribution, but we will deal with it probably relatively rapidly I suspect.

Rohith Chandra-Rajan
Thank you very much.

Question 3 – Raul Sinha, JP Morgan
Morning William, thanks very much for taking my questions. Maybe one, just to follow up on the discussion previously. I was just wondering, at a high level, what do you think of the utility of purely focusing on the mortgage margin when swap rates and rates in general are moving up so rapidly? Just given the timing differences you have talked about, because there is a lot of focus I think, from investors and analysts, on just your mortgage spread and using the mortgage spread as a proxy for the Lloyds overall margins, but clearly it appears that tailwinds on the deposit side are obviously much stronger and realised much quicker than the feed through on the mortgage pressure side. So was just interested in your broader thoughts on the utility of focusing on the application and the completion margin on a quarterly basis. That is the first question.

The second question is just a follow-up to what Omar was asking in terms of deposit pass-through. What have you actually realised so far in terms of deposit pass-through rates? It looks very low from the outside, and it appears that the large banks aren't really passing on very material rate hikes so far, but there are clearly some very high interest rates in the market on savings products. And obviously you had very strong deposit inflows in Q1 as well, so are you starting to expect this pricing environment to change on the deposit side? Just given the amount of surplus capital or surplus deposits the industry seems to be sitting on. Thanks.

William Chalmers
Thank you for the question Raul. On the first question, I think you are absolutely right to point out the right way to look at the overall interest rate and mortgage margin environment is holistically. I think we have described that, certainly I have tried to put forward that argument, in the context of various quarters in the past, where you need to look at interest rate movements and mortgage pricing movements in the same bucket if you like, look at them at the same time. Because as we have seen, where we see swap price movements, that is advantageous from an earnings point of view, particularly if the base rate rises come about shortly thereafter. That is advantageous for the net interest income. Of course, some element of that is likely to be offset in the context of narrowing mortgage spreads as those same swap prices movements take place. But there is a give and a take here, and as said, our business both now and looking forward, is a net beneficiary from that overall move. It has been so far, we expect it to be going forward. So that is one point.

The second point, per your comments Raul, is from a timing perspective, the bank base rate changes and the associated liability margin widening that comes with that, alongside the reinvestment of the structural hedge, as maturities become available, and if we consider the size of the structural hedge in the context of deposit increases, those benefits start to accrue pretty much from day one, particularly the bank base rate changes, and then gradually they build into the hedge. The mortgage margin plays through as the mortgage book matures. And so you will see the mortgage margin plays a role in context of the NIM in quarter one for sure. It will play a little bit more of a role in the context of the NIM in the second half of this year as the mortgage book rolls over. And it will play a stronger role in 2023 and 2024.

So again, coming back to this point around looking at the whole, we are a net beneficiary of those interest rate changes, the swap moves, the base rate changes and the mortgage margin compression. That is a net benefit, a net positive, for our P&L, for our interest income line.

Moving on to the second of your questions, the deposit pass-through question. The way that we look at deposit pass-through is a function of three main parameters. One is about offering, frankly, value and service to our customers. That is very important to us, our customers come first. At the end of the day they are what the business is, and we are building a strategy based upon our customers. So we are very observant of that and it is an absolute priority for us.

The second, is the overall balance sheet need of the business, what do the funding needs of the business look like. At the moment we have a loan to deposit ratio of 94 per cent, which is a very liquid balance sheet. We have seen deposit inflows now of £70 billion since the start of the pandemic, which is what sponsored that loan to deposit ratio. So that is a factor in determining how we look at the deposit environment going forward against asset growth needs that we have.

And then thirdly, we have to look at what the competition does, as your comment indicated Raul, and we keep a close eye on that. We aim to remain competitive in the customer services and products that we offer, and we believe we do. I think you will see headline rates from time to time, you will see increases on certain products from time to time. But it is always worth looking behind the headline, as to how broad that pricing change might be and therefore what the overall competitive implications of it might be.

As we look forward and we adjust deposit pricing, I think it is inevitable, and history would suggest, that at very low interest rates there tends to be relatively modest pass-on of base rate changes simply because what you are doing is essentially allowing the liability margin to recover to something more like what it looked like before we came into these very, very low interest rate environments. It is also inevitable that as bank base rate changes and go up, that institutions like us are likely to respond to that, in terms of passing a little bit more on over time. Precisely how fast that development happens depends upon those three factors that I mentioned just a second ago.

Raul Sinha

Thank you, that is really helpful. I guess just one unrelated follow-up. Is there any capital headwind that we should be thinking about for the remaining quarters of the year apart from the pension contribution? Just in context of the fact that the capital generation target was not updated in Q1. Thanks.

William Chalmers

A couple of points on capital generation. First of all, we don't offer guidance so much on capital generation. I think we talked about an average of 150 basis points over the course of 2022 to 2024 in our 24th February results presentation. But that was an average over a period of time, with inevitably years differing in that respect. But having said that, what we have seen, as I said, is strong capital generation in the first quarter of this year. Looking forward, looking at the components of that, I expect the continuity of strong core banking build within that capital build for the remaining quarters. We will get some tailwinds and some headwinds within that. So the headwinds will be, we had RWA benefits in the first quarter, likely to be less in quarters coming forward. Tailwinds, we are likely to see reduced pension contributions clearly in the context of us having accelerated into Q1. Also in Q1 we didn't have an insurance component to the overall capital build. And so, adding all those together, two comments really. One is I think we will continue to see pretty strong capital build through the course of the year. I don't think you are necessarily missing any big items, none that I would call out as such. And overall I think we are likely to be well ahead of that 150 that was mentioned on 24th February.

Raul Sinha

Thanks very much.

Question 4 – Jonathan Pierce, Numis

Hello there, I've got two questions and actually they are on exactly the same topics as the last set of questions. Sorry about that. But coming at it slightly differently, I do wonder whether you are still being slightly cautious on this mortgage margin point by lumping together the benefits of the managed margin and the hedge income and saying that will more than offset the mortgage margin declining in recent months. Because, if I just think about the hedge alone, we have seen 100 basis point increase in the reinvestment rates in the hedge since the start of the year, whereas maybe mortgage spreads are down, I don't know 20-30 basis points. So even though you have put a lot more mortgages through the pipes every quarter than what the structural hedge reinvestment is, it feels to me like the hedge is providing pretty much a complete offset incrementally versus the extra pressure that is coming through on new business mortgage margins and therefore what you are seeing is really just a pure flow-through in the benefits of the managed margin. Am I missing something there? Because I really can't get too worried about the movement in mortgage margins that we have seen since the start of the year for that very reason.

William Chalmers

Thanks for the question Jonathan. I am not sure you are necessarily missing anything, no. I guess a couple of points. One is, as said, in the context of the rising rates we see benefits from that in the hedge as you pointed out. We see benefits from that in the context of bank base rate changes that should follow. We are forecasting two more bank base rate changes this year, one more than we expected on February 24th to bring it to 1.25 at the end of the year. And we also see benefits from the overall volumes that we have in deposits as mentioned. So those are benefits that we see, I don't think you are missing anything in that respect. I think on the mortgage side, we are seeing application margins that are below completion margins of 85, and I mentioned in answer to Rohith's question earlier on, that actually application margins in Q1 have been outside of that 75-100 basis points too and we will see that flow through.

We have about £90 billion of mortgages maturing in any given year on a roughly £300 billion book. And so the rates at which we had written those mortgages in the course of recent years, particularly high rates in 2020 and 2021, that provides quite a significant step down for those mortgage maturities as they mature in the remainder of 2022 but particularly going into 2023 and 2024. So there is a step down from that and we have given some indication of that previously. That element ought not to be underestimated, in the context of the rising rate and spread compression market that we are seeing. But as I said, I would call out that we are a net beneficiary versus where we were on February 24th.

Jonathan Pierce
I mean I absolutely accept the mortgage refinancing headwind that is coming later this year, next year, on those mid-pandemic two-year fixes but I was really just talking about the separate issue of movements in mortgage margins that we are seeing on new business since the start of the year, that is helpful, thanks William.

Can I ask a second one on deposit beta? We can work out from your slides, showing the ten basis points in the margin improvement was from base rates in the quarter, that probably each 25 basis point rate hike so far has helped the managed margin by probably £350 million. Whereas I think your guidance at the end of the year on the 50 per cent pass-through assumption was £200 million including the heads so maybe £150 million managed margin. Am I in the right ballpark there? Because I am thinking about how we roll through the full period benefit of Q2, because the sort of base rate average in Q2 versus Q1, 30 basis points, is not dissimilar actually to what Q1 was versus Q4. In other words, are we looking at the moment at about £350 million per 25 basis point hike? And should we see, even absent any further base rate increasing in Q2, another high single-digit improvement in the margin from the flow through of the February and March rate hikes into Q2? Thanks.

William Chalmers
Thanks Jonathan. A couple of comments to make. One is, just to reiterate the point around base rate changes that we have put into the economic forecast for the remainder of this year which you have noted. The second is, as your comment really alludes to, we have seen relatively modest pass-ons in the course of the late part of last year and beginning of this year. Indeed, we have seen these relatively accelerated base rate changes, certainly versus our expectations from December onwards. So that combination has led to some of the outperformance you have seen in Q1. And then that leads to the third point, which is to say these base rate changes and the effects of them on the liability margin, they stay with us for this year and they stay with us for next year and beyond. It is not transitional, it stays in the interest income, provided of course that we don't compete it away in so far as that margin has been widened to date, that stays with us.

The fourth point is the sensitivity we have given, which is 175 rather than the numbers you have given Jonathan. But as you say, your numbers were based on slightly different assumptions. 175 is based on the 50 per cent pass-on assumptions and indeed a full asset side pass-on in the context of mortgage balances and spreads. What I would say and perhaps this is helpful, is that it is roughly linear. That is to say that when we look at the overall component of our sensitivity, that component which relates to liability margin management is roughly linear in terms of the relationship that it has 50 per cent versus zero versus 100 per cent.

Jonathan Pierce
Okay great, thank you for that.

Question 5 – Joe Dickerson, Jefferies
Hi good morning. Most of my questions have been answered but could you discuss on the £800 million COVID overlay that is sitting on the balance sheet, what are the hurdles that need to be met before you look to release that, or do you just plan to bleed it out as credit starts to normalise on an underlying basis? Thanks.

William Chalmers
Thanks Joe, it is an important question. As you say we have COVID related judgements within our overall ECL now just shy of £800 million, that is composed of two main blocks. One is the £400 million Group overlay that is essentially an insurance if you like against changes in the conditioning assumptions on which our economic forecasts are built. The second is a further amount of just shy of £400 million which is essentially saying we would have experienced higher levels of default, but for various forms of government support programmes that are in place. That second block is in order to compensate, temporarily, lower default ratios. Commenting on each of those, Joe, which shall inform how we look at them going forward. For the £400 million release, what we would need to see in order to reconsider that is low and sustained low levels of infections number one. Number two a period of no new emergence of vaccine resistant viruses. It is worth remembering today that it is only a matter of weeks ago let's say eight weeks ago or thereabouts that we were at the height of the omicron induced virus and nobody quite knew where that was going to go. So although it seems like a long time ago, in fact it wasn't. There is no doubt that as we go through this year, we will take a look at that environment and see whether or not we indeed have a sustained low level of infections and indeed whether or not there is emergence of any new viruses and whether they are vaccine resistant. Off the back of that to be able to re-examine the £400 million that is the group central judgement.

On the second piece, it is a question of how asset quality performs off the back of the withdrawal of government support programmes. So far, the performance has been very benign as I mentioned in my comments, the underlying performance of our portfolios, retail and commercial, have been very strong which gives you confidence that actually of that amount of slightly less than £400 million that is there for the potential increase in defaults as these support programmes withdraw, so far not much has been used up. We just have to see how the asset quality performs in the context of the weeks ahead of us before taking another look at that. But hopefully that gives you some idea of how we are looking at it.

Joe Dickerson
That is very helpful, thank you very much William.

Question 6 – Chris Cant, Autonomous
Good morning, thank you for taking my questions. If I could just come back on the deposit beta point, to do the same maths as on your slides with the 10 basis point improvement in the quarter. You talked about it being fairly linear in terms of how the deposit beta assumption materialises into the actual NII movement we are seeing. But what we have seen in the first quarter is about double your disclosed full year sensitivity, so implicitly the pass through wasn't very limited, it is virtually nothing. Is that a fair inference or is there also a variance in the first quarter in terms of the quantum of managed margin deposits that you thought you had versus what you now actually think you have? That will be the first question please.

And second on the cost of living point, I thought your comments around the £100 million sort of add on within the mix of your macroeconomic variable change, was quite interesting. What do you expect to see here in terms of customer behaviour? There are a few data points kicking around, I think there was a data point from Centrica recently about the number of customers now in arrears on their gas bills has gone up by some multiple versus where they were a year ago. Is your take that it is just about your customer profile and you don't overlap in the Venn-diagram? which I sort of struggle with given your size in the UK market. Or is it that you think the people who are going to get into real difficulty as a consequence of that cost of living, are not part of your cohort and where others are maybe struggling, they go into arrears on their gas bill first but they are not going to stop paying their credit card. Is that how you are thinking about it? I am just seriously thinking about a little bit more colour on that cost of living comment please. Thank you.

William Chalmers
Sure, thanks Chris. In terms of the performance in the first quarter on net interest income and the relationship of that with sensitivity. As I said before, I think it is fair to say that the bank base rate changes have made more of a difference than the sensitivity would suggest and a lot of that comes down to the extent to which the liability margin has been restored in the context of slightly higher interest rates versus the near zero interest rates we have experienced over the last few years. So that is certainly a factor. I mentioned a linearity and perhaps I should have been more precise in the answer to the question for Jon, but if you look at our overall £175 million of sensitivity in year one, around half of that is related to effectively the 50 per cent pass on assumption. So that is where the linearity comes in for that half, which is related to the parts of assumption, is around half of the overall £175 million and that is where the linearity kicks in which hopefully helps you with your numbers as we look forward. So literally what does that mean? Half of £175 million therefore is related to pass on assumptions.

As we look forward as I said, it is likely that as rates go higher, we will seek to pass on more in the context of making sure that we deliver customer value as well as service and making sure that we remain competitive and at the forefront. Off the back of that, we would see pass on assumptions that converge towards our 50 per cent sensitivity that we show you in the illustrations that we have given.

I would say that the underlying performance of the business in the deposit area has been very strong and so when we look at the quality of the business on the liability side you can see the further £4 billion or so of deposit inflows over the course of the first quarter, and that feels very strong from a franchise point of view.

The cost of living point, just to give you some thoughts on that really. We do obviously see quite a lot of data in terms of how our customers are responding to tougher conditions from a cost of living point of view and the inflationary environment. So, to give you one or two data points that we think are interesting. We have seen around 1.2 million subscription payments have been stopped by our customers since summer of 2021. And those relate significantly to things like television streaming services and they also relate to more discretionary items of expenditure such as gym subscriptions and that sort of thing. So we have seen signs of customers somewhat tightening their belts with a respect to discretionary expenditures and we keep a close eye on those because they are also the data points or informers as to whether or not we need to proactively reach out to customers and offer them support and financial planning help and so forth.

In terms of our approach, a couple of points about how we see the economic environment feeding through. If you look at our economic assumptions, we still maintain GDP growth in 2022. Now admittedly, we don't see much occurring in the remaining three quarters of this year because most of it is already banked as of Q1. But nonetheless, it is a positive GDP environment albeit less so than it was on February 24th when we talked about our Q4 assumptions. Likewise, and very importantly, we see unemployment remaining low, 4.1 per cent in 2022 only gradually rising thereafter in 2023. So those are very low levels of unemployment and as you know Chris unemployment has always been the leading indicator for asset quality default. So as long as unemployment levels remain low, then I think the consequences of that for our portfolios will be measured by those unemployment levels and therefore be manageable.

Further point, we have seen over the pandemic savings cushions. I mentioned we have seen deposits increase by £70 billion since December 2019. Significant build up in savings cushions. But then perhaps more importantly when we look at the portfolio's, we are careful about the extension of credit, and we try to make sure that we only extend credit where we believe the customer can afford to pay it back, predominantly for their interests. We also stress our portfolios, so we stress secure portfolios for example to now well over 7 per cent for affordability.

Our unsecured book, which is obviously most likely to be at risk potentially in this context, is a prime unsecured book, and you can see that testified to by some public securitisation data and credit reports that are available. It is not to say that we won't necessarily see some uptick in impairment, if inflationary conditions persist and economic conditions worsen. But on the other hand it is mitigated by these factors.

Then moving onto commercial again, affordability checks, affordability criteria are key; stressing likewise. We then look at cashflows, 80 per cent of the SME book is secured. We are very careful about early warning triggers to try and make sure that where defaults do occur, we offer customers assistance where we can again both in their interests and ultimately in interests of lowering losses. So I think the data that we see in sum is an indication as to how customers are responding. Our view is that the economics are looking tougher and the cost of living is a big part of that. But overall we see the unemployment rate staying low which is an important data point. Finally we see the portfolio in both retail and commercial as being well positioned, to more adverse economic circumstances.

Chris Cant
Thank you.

Question 7 – Andrew Coombs, Citi
Good morning, I have one follow-up question following on from Joseph's and Chris's questions and then one on capital. On the follow-up, I am interested in the point on the area of the overlay because we have been talking about when you might release this for some time and I remember the discussion a year ago was really when you had more resilient data per CGRS, and we now have that resilient data. I am interested that you are still attaching that overlay to very much COVID based measures, so you are talking about prolonged periods of lower levels of infection, vaccine success. But is it a case now that that overlay becomes fungible, so even if we were to see lower levels of infection and success of vaccines that now you might rather wait and see how the cost of living crisis proceeds, how the Russia-Ukraine conflict proceeds from here before releasing that overlay? So, any comments around that.

And then the second question on capital. In your earlier comments where you said you felt you are going to pass the 150 basis points guidance for this year. I see no reason why that couldn't be the case for future years as well given the step up in your interest margin even with the cost of risk normalisation. So as that 150 basis points was baked into your plan and you now expect to exceed that what do you plan to do with the extra organic capital generation? Would you accelerate the pension contribution even further, would you look at more RWA growth, or is the potential for even larger buybacks than you have currently had plugged into your plan?

William Chalmers
Thank you for that Andrew. On the first of the questions as to the overlay, it is worth saying that the provisioning assumptions as to COVID and the provisioning assumptions as to cost of living are not fungible. They are very much built up being of their own justifications, separate pillars as it were. When we look at the Coronavirus related provisions there, as said, we have two blocks, the £400 million and just shy of £400 million and hopefully the comments I gave earlier on around the conditions to release the first of those are clear. In the great scheme of things, when you have only had an outbreak of Coronavirus circa eight weeks ago. Looking at it in the context of the second quarter, it doesn't seem to be awfully different to looking at it in the context of the first quarter. So we will look at it as the year goes on but as I say in the great scheme of things, I am not sure the timing difference is going to make a lot of difference to our capital ratios, to the business, to our stakeholders and so forth. But we will get to it and we will look at it over the course of Q2 I am sure.

Secondly on the cost of living adjustment, the inflationary adjustments, what we have done there is to look closely at potential probability of default in terms of lower income segments in unsecured number one. Number two, to look at some of the segments within our commercial book that are more affected by inflationary pressures, particularly input pressures. So we have looked at those sectors that we lend to and in each case we have taken a view on how that might affect probability of default and then collected up a provision as inflation compensation, if you like, to compensate for that. Now that is based upon our economic forecast right now and clearly if inflation takes off in a bigger way than we currently forecast, if economics deteriorate more than we currently forecast, then we will have to relook at those. But that overlay of circa £100 million is consistent with the economic forecast that we have in place right now.

It is also worth saying that it comes on top of an examination of the severe stress scenario at the end of last year which was also conducted with an inflationary watch, if you like, and that contributed a £60 million overlay for the severe ECL case or the severe scenario built into our ECL. So, the total inflationary adjustments is therefore more like £150 million or thereabouts as again, post model adjustments for the inflationary scenario.

But again to return to the point, they are not fungible, first to the Covid. If Covid runs off because of a low level of infections and no new virus, then we will look at that and we will consider whether or not we need to effectively release those provisions. Quite separately to that we will look at economic environment including the potential asset quality repercussions of higher inflation and will determine how much ECL we set aside for those conditions.

So the second of your questions on capital generation Andrew, I have made comments around the strength of capital generation in Q1 and as I said we expect that to remain pretty strong for the remainder of this year. I think as we look beyond this year, there is clearly a long way to go number one. There are clearly many uncertainties that are out there, number two. But the business remains relatively well positioned and so we feel comfortable with the overall development and progress that is being seen in the business. Therefore I wouldn't really want to go into too much speculation about what we might do with capital in the period thereafter. Safe to say that we feel comfortable with where the business is today, and I have given you an outlook for 2022.

Andrew Coombs
Thank you.

William Chalmers
Thank you very much indeed to everybody for taking the time to listen.

END

FORWARD LOOKING STATEMENTS

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