LLOYDS BANKING GROUP PLC – Q3 2022 INTERIM MANAGEMENT STATEMENT – PRESENTATION TRANSCRIPT
(amended in places to improve readability only)

Thursday 27 October 2022 – 9.30am

LBG:
William Chalmers, Chief Financial Officer

William Chalmers
Good morning everybody and thank you for joining our Q3 results call. Let me start with an overview of the key messages on slide 2.

As you all know, we are operating in a fast evolving and uncertain environment. In this context and as ever, we remain focused on supporting our customers.

The Group is performing well. During the third quarter we saw further income growth, supported by the net interest rate environment and ongoing robust business volumes. We continue to observe strong asset quality and stable credit trends across the portfolio. Our robust financial performance is supporting the update to our guidance for 2022.

Strengthening the income from an increased NIM outlook, alongside continued cost discipline enables us to maintain our RoTE guidance and to give further clarity on our strong capital build. This is despite the tougher macroeconomic outlook, which drives the forward looking impairment charge we are taking today.

We continue to progress our net zero ambitions. Last week we announced new sector-based emissions targets for 2030, alongside a new net zero ambition for our supply chain. These are important commitments as we continue to support the transition to a low carbon economy. Our strategic delivery and robust business model position the Group well for the future. We announced our new strategy in February and the associated investment is now well underway. We will update the market on our progress in more detail at the full year.

I will now turn to slide 3 to look at what we are doing to support customers in the current environment.

The vast majority of our customers are demonstrating resilience and adapting to the cost of living increases. However, we know many are concerned about the outlook and we are committed to proactively helping where it is most needed.

In Retail, for example, we are contacting vulnerable customers with advice and guidance on relevant product adjustments.

In Commercial, we are reaching out to Business Banking clients with specialist relationship manager support.

In Insurance, we are removing monthly interest charges on home insurance products, enabling customers to spread the cost of their policies. As said, we are committed to proactively supporting our customers. We remain vigilant for any signs of stress across the portfolios.

Let me now turn to slide 4 to look at an overview of the financials.

Lloyds Banking Group has delivered a robust financial performance in the first nine months of 2022.

Net income of £13 billion is up 12 per cent on the prior year, supported by a stronger net interest margin of 284 basis points, growth in other income and a continued low operating lease depreciation charge.

We remain committed to our market-leading efficiency. Operating costs of £6.4 billion are up 6 per cent on the prior year. This includes stable BAU costs, alongside higher planned strategic investment and the costs associated with our new businesses.

Observed asset quality remains very strong. Impairment has increased to £1 billion, but this is largely driven by the weaker economic outlook and associated scenarios adopted in Q3. I will go into this in more detail shortly.

Taken together, this robust Group performance resulted in statutory profit after tax of £4 billion in the first nine months and a return on tangible equity of 12.9 per cent.

Our financial performance, alongside effective management of risk weighted assets, has resulted in capital generation of 191 basis points for the year to date.

I will now turn to slide 5, to look at the ongoing strength in our customer franchise during the third quarter.

Our mortgage book continues to grow, including open book growth of £1.8 billion in Q3. Credit cards have continued their gradual recovery. Balances are up £0.1 billion in Q3, with improving spending levels, particularly in discretionary categories, although much of this is offset by customer repayments.

Unsecured personal loans have increased £0.3 billion in the quarter, in part due to our enhanced pre-approval capabilities for attractive, low risk customers in the intermediary channel.

Commercial Banking balances are up £0.6 billion in the quarter. We are seeing attractive growth opportunities within our Corporate and Institutional franchise, alongside the effect of FX movements. These are partly offset by repayments of Government support scheme loans in SME.

Looking briefly at the other side of the balance sheet. We continue to see inflows to our trusted brands. Retail deposits are up £1.5 billion in the quarter, building on the growth seen in the first half. Within this, current accounts are up £2.3 billion in Q3, more than offsetting lower savings balances in our tactical brands, with our relationship brands essentially flat.

Commercial deposits are up £3.5 billion in the third quarter. Note that part of this growth is short-term placements which are likely to reverse in Q4.

Alongside, we continue to see good organic growth within our Insurance business, including over £6 billion of net new money in the year to date.

I will now turn to slide 6 and the Group’s income growth in a little more detail.

Net income of £13 billion is up 12 per cent year on year, with higher NII and other income, alongside lower operating lease depreciation. Net interest income of £9.5 billion is up 15 per cent on the prior year, benefitting from a stronger net interest margin and higher average interest-earning assets.

AIEAs of £451.4 billion are up £8.4 billion on Q3 2021. Within this, mortgage growth is more than offsetting the lower average balances in SME. The year to date net interest margin of 284 basis points is up 32 basis points on the prior year. The margin in the third quarter was 298 basis points, benefitting from the bank base rate increases and favourable structural hedge reinvestment, more than offsetting the drag from mortgages.

In respect of mortgages, completion margins were around 60 basis points in Q3, in the context of considerable swap volatility. It remains unclear exactly where margins will settle, but we are seeing persistent material pricing moves compensating for the recent swap rate increases.

Looking forward, our updated economic assumptions now include a yearend base rate of 4 per cent. This will act as a tailwind to the margin. Indeed, with the benefit of this and other factors, we are seeing sustainably higher margins than previously expected. Accordingly, we are enhancing our 2022 net interest margin guidance to greater than 290 basis points.
With respect to volumes, we continue to expect low single digit percentage growth in AIEAs in 2022.

Now turning briefly to other income. OOI of £3.8 billion year to date is up 2 per cent on the prior year, while £1.3 billion in the third quarter is roughly in line with recent periods. Within OOI, Retail other income is up 11 per cent year on year, including improved current account and credit card performance. Commercial Banking is up 3 per cent given financial markets and transaction banking income. Insurance, pensions and investments income is up 6 per cent, reflecting a good performance in workplace pensions and bulk annuities.

And finally, within our Equity Investments business, income is materially lower given the non-recurrence of exceptional gains in 2021 and one-off charges in Q2 2022, impacting the Business Growth Fund.

Going forward, we continue to expect other income as a whole to build gradually, supported by customer activity levels and our ongoing strategic investments. Of course within this you should remember that we will see an impact from the implementation of IFRS 17 in 2023. We will go into this in more detail at the year end.

Given the continued focus on interest rate impacts and the structural hedge, I will now look at these in more detail on slide 7.

The structural hedge has been a material net tailwind to Group income in the first nine months of the year. Gross hedge income was £1.9 billion for the nine months, while Q3 alone was around £120 million higher than Q3 last year.

Looking forward, in the current rates environment we expect structural hedge income to be stronger in 2022 than in '21 and to build significantly again into 2023 and 2024 as the hedge reprices.

In this context, the nominal balance of the structural hedge remains around £250 billion with a weighted average life of around 3.5 years. The £65 billion growth of the hedge nominal balance since 2019 incorporates about £40 billion of the more than £70 billion of deposit growth since the end of 2019. This is alongside £17 billion of increased eligibility from previously existing deposits and £9 billion utilisation of the previous buffer.

As a result, we have built a substantial buffer of balances which represent deposits that have not yet been taken into the hedge. This buffer now stands at £31 billion, providing significant protection in the event that deposits prove more rate sensitive than expected.

As you have heard many times, the Group is positively exposed to rising rates. We currently expect a 25 basis point parallel shift in the yield curve, and associated base rate rise, to benefit interest income by about £150 million in year 1. This is lower than reported at the half year, reflecting the fact that we have deployed the hedge into the recent rising rate environment and hence have a lower level of maturities in Q4.

I should also note that the sensitivity is likely to pick up again going forward, as we have over £38 billion of maturities expected in the remainder of 2022 and 2023.

As you know, our sensitivity is illustrative and based on the same assumptions we have given before, including the 50 per cent deposit pass through. Clearly, the actual pass through experience could differ from our 50 per cent illustration. And for every 10 percentage point reduction versus the assumed pass through, we expect an additional £50 million of NII in year 1 for a 25 basis point shift. As noted before, this is broadly linear, so you can double that sensitivity for a 50 basis point shift.

Now moving to costs on slide 8. Operating costs of £6.4 billion are up 6 per cent on prior year. As expected, essentially stable BAU costs are alongside planned higher investment and costs associated with our new businesses. We continue to expect 2022 operating expenses to be circa £8.8 billion. Our cost, income ratio of 47.8 per cent in Q3, including Remediation, has significantly improved over recent quarters.

Looking forward, like all organisations, we are impacted by inflationary pressures, but we retain our rigorous cost focus. We will look to offset higher costs wherever possible, as we have with the circa £65 million expense associated with the one-off payment to staff in Q3.

We will provide an update on the cost and investment outlook at the year end. I should highlight at this point that the phasing of our strategic investment is expected to peak next year.

As mentioned, remediation remains low, at £89 million for the year to date and £10 million in Q3. Within this, there is no charge for HBOS Reading, although uncertainties remain.

Looking now at impairment on slide 9.

Observed asset quality remains very strong. The net impairment charge for the third quarter is £668 million. This includes £618 million in respect of the updated macroeconomic outlook and associated scenarios, partly offset by the release of the remaining £200 million central COVID-related overlay.

I should note that this Q3 MES charge is materially driven by a very severe downside case. This is a function of our methodology, but it is also an unlikely outcome. The Q3 charge, pre-updated economic scenarios, of £250 million reflects very strong observed credit quality. It is equivalent to 21 basis points for Q3, or 15 basis points year to date, in line with our previous guidance.

MES and observed charges together bring the net year to date impairment charge to approximately £1 billion, equating to an asset quality ratio of 30 basis points.

As a result of the provision build in Q3, driven by the weaker economic outlook and associated scenarios, our stock of ECLs has increased to £5 billion. We now expect the net asset quality ratio to be around 30 basis points for 2022.

Turning to slide 10, I will consider customer behaviour across our businesses.

We are seeing few signs of pressure in our customer base from cost of living increases. Credit card spend in September was up 16 per cent compared to September 2019, driven by our middle and high income customer bands. Indeed, our customer base is continuing to increase discretionary spending, providing further opportunities to adjust outgoings if needed.

Alongside, regular minimum payers in the card portfolio remain at consistently low levels.

We continue to see stable trends in SME overdrafts and revolving credit facilities. Indeed RCF drawings remain at around 80 per cent of pre-pandemic levels, while invoice financing debtor days have remained broadly stable throughout the year.

Let me now turn to slide 11 and the resilience of our portfolios in the current environment.

Our mortgage book now stands at £311 billion. This is a very high quality portfolio. The average loan to value is 40.3 per cent and 96 per cent of the book has an LTV below 80 per cent. Just 0.5 per cent has an LTV above 90 per cent.

We are now assuming peak to trough house price reductions of 10 per cent, but even after that, given the LTVs, our customers would retain significant equity.

Our Commercial portfolio is also very high quality. Over 70 per cent of exposure is to investment grade clients, while around 90 per cent of SME lending is secured.

Within Commercial, the real estate portfolio has been significantly de-risked in recent years. Net exposure is now £10.9 billion and the business has an average LTV of 39 per cent, while just 11 per cent have an LTV above 60. Average interest cover of the portfolio is basically stable at 4.4 times.

As you can see on the slide, there is a very slight increase in new to arrears in unsecured. However, these levels remain very low across our portfolios, at or below historical averages and below pre-pandemic levels. In short, customers are showing resilience and performing strongly.

Moving on, I will now look at the Group's updated macroeconomic scenarios on slide 12.

As mentioned earlier, the Group's updated macroeconomic scenarios are driving a circa £600 million charge in Q3, partly offset by a £200 million release of our central COVID adjustment.

We now assume base rate peaks at 4 per cent in Q4 2022, before starting to fall in early '24 as inflation is brought under control. Inflation peaks at 10.7 per cent in Q4, while unemployment is expected to increase to 5.5 per cent in Q1 2024. We are now assuming a fall of 8 per cent in house prices in 2023, or a 10 per cent peak to trough fall.

Importantly, because of the strength of recent performance, this sees average house prices reverting to around the level of Q3 2021. This means the vast majority of customers will still have experienced net price gains during the life of their mortgage product, even after this adjustment.

As ever, we have provided the full range of upside, base, downside and severe downside scenarios in the appendix. We have also provided the ECL by scenario.

You can see the downside and particularly the severe downside scenario, significantly impact our probability weighted expected credit loss. This now drives a difference of almost £700 million between the actual ECL we hold, versus our base case expectation and illustrates the conservatism of our approach.

Moving on, I will now turn to statutory profit on slide 13.

Following the reporting changes set out at the 2021 year end, Restructuring now reflects only M&A and integration costs. The charge of £69 million for the nine months includes the early integration costs relating to the acquisition of Embark.

The volatility line includes £74 million of positive banking volatility year to date. This is more than offset by £144 million of negative insurance volatility, principally driven by rising interest rates. The line also includes the usual fair value unwind and amortisation of purchased intangibles. Year to date statutory profit after tax of £4 billion and the return on tangible equity of 12.9 per cent represent a robust performance. We continue to expect the RoTE for 2022 to be around 13 per cent, even after the impairment and volatility charges that we have seen in Q3.

A quick word on book value. Tangible net assets per share of 49 pence are down 5.8 pence in the quarter. This is largely due to the impact of movements in the cash flow hedge reserve, similar to the movement that you saw in the second quarter. As you know, this is a timing issue that will unwind and has no effect on capital.

Turning to slide 14 and looking at our RWA management and strong capital generation in the nine months.

Risk-weighted assets of £211 billion are down £1 billion, excluding the regulatory inflation on the 1st of January. Underlying lending growth of £3 billion has been more than offset by model reductions and ongoing portfolio optimisation. As before, we are seeing no impact at this point from credit migration.

Capital generation of 191 basis points year to date is strong and reflects robust financial performance. This includes 169 basis points of underlying banking generation, as well as the £300 million interim dividend from the insurance business. It is also after the full £800 million fixed pension contribution for 2022.

The CET1 capital ratio of 15 per cent is very strong and well ahead of our ongoing Board target of circa 12.5 per cent plus a management buffer of circa 1 per cent. The capital ratio is after taking 60 basis points of dividend accruals, as well as substantially all of the expected £1 billion of variable pension contributions for 2022.

As you will be aware, the 2022 buyback programme was successfully completed in October, buying back over 6 per cent of outstanding shares.

Looking forward, we continue to expect 2022 closing RWAs to be around £210 billion. Based on this and the robust financial performance to date, we now expect capital generation for 2022 to be between 225 and 250 basis points.

The Board remains committed to shareholder remuneration. As always, we will consider both the dividend and further capital distributions at the year end.

Now turning to slide 15 to wrap up.

In summary, the Group is performing well and faces the future with confidence. The current environment is concerning for many people. As always, we are committed to maintaining the support we give to our customers. However, our franchise is resilient and our low risk portfolios are well positioned for more challenging times.

The Group has delivered a robust performance in the first nine months of 2022 with improving net interest income and cost discipline driving robust profitability, despite the revised macroeconomic outlook.

Looking forward, the Group's robust financial performance and revised economic outlook are reflected in our updated guidance for 2022. We now expect the net interest margin to be in excess of 290 basis points. The asset quality ratio to be circa 30 basis points and Capital generation to be between 225 and 250 basis points.

The rest of our guidance for 2022 remains unchanged.

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

Question and Answer Session

Question 1 – Joe Dickerson, Jefferies
Good morning, a couple of quick questions. Thanks for the disclosures on slide 7 for the additional sensitivity around the pass through rate. Could you give us a sense of where, what the ballpark is, on the current year to date pass through rate? Presumably this will start to shift as rates cross, let's say, three per cent or some level like that, but I guess what has been the experience thus far is the first question. And then similarly, on net interest income, just the way to think about the £38 billion of maturities that you can earn at probably a couple of hundred basis points higher spread on those, plus whatever you decide to do with the £31 billion unutilised buffer. Is that probably at current rates? Thanks.

William Chalmers
Thank you Joe. Just to take each of those in turn. On the pass through activity, we haven't given a specific number for the year to date, but since the base rates started to change at the beginning of the year we passed on a little below the 50 per cent assumption that we have seen. I think when we look at that we look at three things essentially. How do we deliver customer value; clearly that is about prices, it is also about many other things too including service, distribution network and so forth. How do we compare versus the competition; where our pass through has been very much in line, and how does the funding of the balance sheet look; where at the moment, as you know, we have a loan to deposit ratio of 94 per cent, so a very liquid balance sheet.

As said, so far we have been very much in line with the sector, we have been below the 50 per cent mark. To your point, I would expect as we go forward, bank base rates continue to increase. We will likely see that pass through increase, and I would expect it to move more in line with our core assumption of the 50 per cent mark that we put forward.

It is also worth saying that we have a number of term offers out there. So there are offers available for customers that choose to lock their money in for longer terms, at more favourable rates, should they choose to. And you will have seen some our offers in that respect over the course of the last few weeks and days.

It is also worth saying that we have had very strong deposit inflows over the course of Q3 as you have seen our number of £6.1 billion, with retail a significant proportion of that including PCA's, current accounts that is, at £2.3 billion in the third quarter. So we continue to see very significant deposit inflows which I think is testimony to the fact that customers still find us a very attractive place in which to put their deposits.

Your second question on NII. On NII it is worth maybe just stepping back. We have as you say £38 billion of maturities over the coming year or so. We also have a £31 billion buffer that I mentioned, and that is a buffer that has increased threefold versus where it was in 2019. I think we will look closely to that. It is in a sense a form of insurance policy I suppose in case deposits prove to be more interest rate sensitive than we expect. But equally based upon on our core assumptions, I would expect some of that buffer to be utilisable over the course of the coming year because I am sure that many of those deposits will stick with us and that will then make them eligible for the structural hedge going forward.

So to the yield point that you mentioned, how do we look at that? The yield on the structural hedge right now is a shade over 1 per cent. As you know, we have a weighted average life of around three and a half years, but over the next several years we will be redeploying that hedge into the existing interest rate environment at that time. What that means now, and for our forecast going forward over the next year or so, is that we will be redeploying that hedge into more like a 4-4.5 per cent environment that we are seeing right now. So quite a considerable mark up from the existing yield that is on the hedge as you can tell.

Joe Dickerson
Great, that is quite helpful, thank you very much. It is just when we look at the outer years of where the market expectations are on net interest income, considering the mechanics around the hedge and the unutilised balances, the estimates out there looked fairly low when we look a year or two out given this hedge dynamic.

William Chalmers
Maybe just pause briefly on that, Joe. As you are seeing, we have enjoyed strong net interest income performance up 15 per cent year on year for the nine months year to date. And that is a function of a couple of different things. We have seen very strong tailwinds in terms of the bank base rate changes and likewise the redeployment of the hedge as you point out. To an extent at least the headwind of mortgage refinancing is starting to hit us and I expect that to continue over the course of 2023 as the fixed rate mortgages refinance into a slightly lower margin environment. But having said that you can tell from our net interest margin development in Q3, which is plus 11 basis points versus Q2, the headwinds are very significantly offset if you like, in fact beaten by the tailwinds. That is to say, the positives significantly outweigh the negatives in terms of margin compositions. I would expect that to continue going forward.

Joe Dickerson
Very helpful, thank you.

Question 2 – Rohith Chandra-Rajan, Bank of America
Good morning, thank you very much. I'd just like to follow up actually on the margin just to start with and just looking at your near term guidance. So that implies something above a 308 margin for Q4. I was just wondering if you could help us with the drivers for that, William. You discussed that a little bit already, but if you could just expand on that, for Q4 in particular. And it sounds like from what you just said that you are expecting further margin expansion from that level next year given your comments on the tailwinds outweighing the headwinds.

And then similarly just on the AQR, so 57 basis point charge on reserve build primarily this quarter, and the guidance for the full year, it seems to suggest that pretty much halving in Q4. And is that Q4 number really what you are expecting in terms of underlying credit quality or is there some additional reserve build in that number as well? Thank you.

William Chalmers
Thank you, Rohith. Just to deal with each of those in turn again I guess.

On the margin point, as said, you have seen our margin in Q3, 298 basis points. You have seen our margin year to date, 284 basis points. And thirdly as you point out, you see our margin guidance for greater than 290 for the year as a whole. Now realistically what that means is that we expect to see continued margin strength going into the next quarter and there are two or three drivers to that.

So if you look at the positives there, again you see bank base rate changes so far year to date. But actually many of the bank base rate changes that we are forecasting up to the 4 per cent destination point if you like are still ahead of us. Likewise the hedge that I mentioned before is redeploying from the previous rate environment that it was executed at into a new rate environment that is considerably more favourable. The average yield as I said before a shade over 1 per cent, now being redeployed into a yield environment more like 4 or 4.5 per cent or so. Those are the principle tailwinds that continue into Q4 and are then, as I said in my comments in the script, we believe much of that is sustained going into 2023.

Now offset against that as said, we see the mortgage book refinancing into a lower margin environment and that provided a headwind in Q3. That is also going to provide a headwind going forward into Q4 and beyond. But on balance it is very clear that the positives are significantly outweighing the negatives here. That implies that the margin benefits from that net balance if you like. And we see that as being a pattern going forward.

The AQR point Rohith. Sorry go ahead.

Rohith Chandra-Rajan
Sorry just on that. I know approval spreads would have been very volatile over the last month or so. But can you give us some indication of how you know what that pattern has looked like?

William Chalmers
It is slightly a separate question in terms of what has been going on in mortgage pricing. So just to address that. Mortgage pricing as you know has been quite volatile over the course of the last quarter or so. We saw mortgage completions of around 60 basis points in Q2, and the mortgage completion number that we have seen in Q3 has basically been the same. However during that time we saw a strengthening of application margins particularly in July and August and I think I talked a bit about that during the course of the Q2 results in August. And then we saw significant uptick in swaps during the course of September which then took margins down towards the end of that month.

As we look today application margins are ahead of that completion margin of 60 basis points but to be clear the volumes at which those application margins are being executed are quite low. And so therefore you will see an impact of the late Q3 completions that we did relatively low margins because of the increase in swap rates get called through into our expected Q4 completion margin. The Q4 completion margin is likely to be affected by those late September swap volatility moves that we saw against which we executed quite significant volumes.

But if I pull that back into the margin commentary, when we look at the margin pattern at the moment, as said earlier on, the tailwinds are outweighing headwinds and in our guidance of greater than 290 basis points for the year as a whole, all of what I have just said about mortgage margins is taken into account.

Now clearly as we look forward the dynamics of the margin development are going to change. We forecast our base rate changes being more or less completed by the end of this year. And so that benefit if you like then comes into the full year in 2023 accompanied by hedge benefits, but bear in mind that the tailwinds if you like are strong this year. They are mainly frontloaded against some of the headwinds which start to come into play a little bit more during the course of 2023.

I will proceed to your second question on AQR. The asset quality ratio as you have seen is guiding towards circa 30 basis points and indeed the asset quality ratio year to date is just that, 30 basis points. Now essentially what that means, just arithmetically, is that the fourth quarter can’t be terribly different to what we have seen year to date. What is that composed of, two points worth making, one is the observed credit quality has been very strong. As you have seen year to date it is 15 basis points, if you look at the observed component of our impairment charge. Even within Q3 the observed credit quality remains very strong, 21 basis points for Q3.

As we look at the year to date the effect of the multiple economic scenarios, and indeed as I mentioned in my script the particular effect of the severe scenario, is what has increased the impairment charge in Q3 and therefore leads in significant part to the overall AQR ratio of 30 basis points for the year to date and also for the year as a whole.

So what we look forward to in Q4 to your point is we assume obviously that the economics remain exactly as we have forecast them as of the end of September. That is a core assumption. What you do see in Q4 is that a roll forward effect on the Stage 1 loans that roll forward into a slightly tougher macroeconomic forecast and pick up the next three months of that slightly tougher macroeconomic forecast as they roll forward. So that has a little bit of an impact on Q4 AQR. As said, that is accounted for and all taken into account in the context of the AQR guidance of circa 30 basis points. Underlying credit rolls through, no additional economic scenarios charged beyond what we have already stated.

Rohith Chandra-Rajan
Thank you, so could I just clarify that? So if it is around 30 basis points for Q4, is it right to assume that that is roughly 20 basis points of underlying credit quality, so similar to what you have seen in Q3, plus 10 basis points of this roll forward on the Stage 1 loans, or is it a different mix?

William Chalmers
Maybe just to comment briefly on the observed credit quality to help you think about that. As said observed credit quality 15 basis points year to date, 21 basis points in Q3. As I mentioned in my comments there is a very slight uptick during that time principally in the unsecured area. However the increase is not as much as it might first appear because Q1 and Q2 were benefiting from debt sales number one, and CRDIV adjustment benefits within our models number two. So actually the increase in the underlying is more modest than you would see based upon looking at the numbers prima facie.

So there is a second thing going in within those numbers which is that because interest rates are increasing the discount for recoveries for already defaulted loans is getting lower. So also within that observed credit performance you are seeing some discounting effects from already defaulted loans.

So for each of those two reasons, one because of debt sales and CRDIV benefit in Q1 and Q2, two because of increased interest rates reducing recoveries for already defaulted loans within Q3, the actual underlying increase in observed credit quality or deterioration in observed credit quality is less than it might first appear.

Now as we roll forward we take a look at several different early indicators, early warning indicators as we call them, for what is going on with customer behaviours and so forth and I have commented upon many of those in the script earlier on. But overall that gives us a sense that the observed credit quality in the book is likely to continue being pretty robust and then as said you get the roll forward effect on the Stage 1 loans that will add to that. But that is really a function of economic scenario modelling rather than anything to do with actual observed credit quality. That together amounts to a likely fourth quarter AQR charge. It is actually fractionally below 30 basis points, but as you can tell it averages up to about 30 bases on our guidance.

Rohith Chandra-Rajan
That’s great, thank you very much.

Question 4 – Aman Rakkar, Barclays
Good morning, if I could ask a question on volumes and capital. Predicated on your assessment of the environment, notably house prices falling and an uncertain outlook in demand more broadly, interested in your expectations for volume growth in mortgages and consumer credit as you look forward, would be my first question.

And then secondly around capital. Obviously note the increased capital generation guidance, and given the start point on the CET1 ratio at the beginning of the year, suggests scope for you to announce potentially pretty attractive distributions at the full year. I guess something to the tune of £4 billion I think post the variable pension contribution which suggests you could easily do another £2 billion share buyback at February. So keen to test my understanding of that, if that is correct? And more broadly your approach to capital in this kind of uncertain backdrop. Are you tempted to operate with a CET1 ratio that is higher than we would have thought previously, I guess is the kind of politics and the optics of the broader backdrop of part of the consideration as well. Is that the kind of thing you worry about, paying too much away in this kind of difficult sentiment backdrop. Any thoughts would be really appreciated. Thank you.

William Chalmers
Thank you, Aman. Both important questions. In terms of the volume environment going forward, I guess our macro assumptions are giving a picture of a slightly more challenged macroeconomic outlook next year versus what we have seen this year. And we

think that is really a function of what has happened globally and to a degree what has happened within the UK. It does seem to us quite plausible, quite likely even, that that will potentially dampen volumes over what you might have seen otherwise. Certainly in the more benign economic environment and potentially versus what we were projecting as of HY. And that is simply a function of the macro environment that we believe we are likely to operate in.

What does that mean? We have had very strong expansion growth in mortgages as you know over the course of the last couple of years, really since the pandemic, in fact starting with the beginning of the pandemic and beyond. So those very strong volumes we think are likely to taper off a little bit as we go forward into a slightly tougher environment.

However we have seen pretty muted overall growth in the unsecured in that time for a variety of reasons including, most obviously, repayment behaviours by customers. And if we see continued spend growth amongst the customer base that we do business with then you know it is possible that the volume effect on those customers in that area may be less significant than what you might see in mortgages for example. But I think within retail therefore overall you are likely to see the macro have some effect upon volume growth.

Within commercial you, broadly speaking, might say the same although, again, I would distinguish there between our relatively healthy growth that we have seen in business opportunities within CIB business year to date and within SME, decent business performance underlying, but actually offset by much of the Government support loans getting repaid. So those are additional dynamics there. But overall a tougher macro usually does make for slightly slower volume growth in what we would otherwise see.

I would just add one final point before capital, which is as you have seen we have taken, what we believe to be, a prudent and conservative view of the macroeconomic outlook going forward. And that is very deliberate because we see the changes going on around us and we have taken a view that we believe fits with that. Having said that, it may be that the macroeconomic environment ends up a little better than our expectations. We took them as of the end of September. We will see how we evolve into next year. It is too early to make that judgement frankly. But if it does then you will see some benefits clearly in terms of the business performance off the back of that and in particular in respect to your question on volumes.

Second point on capital. You are right to highlight the very strong capital performance and capital generation that we have seen year to date and also our guidance looking forward. So we have seen 191 basis points year to date, very strong capital generation and with guidance 225 to 250 basis points. Again very strong capital generation. Within that Q3 performed well with 52 basis points. Broadly speaking I would see similar trends persisting in Q4 which is what lends itself to our guidance. How do we look at that? First and foremost we are absolutely committed to repatriation of capital above and beyond what the business needs to our shareholders. And we have demonstrated that very significantly I think this year with our £3.4 billion of distributions over the course of this year. We then demonstrated it again with a 20 per cent increase at the half year and I have no doubt that the Board will have a discussion towards the end of this year as to what it should do with likely excess capital at that point. That will be a discussion for the Board at the time but it is very likely that we are going to be having it.

How do we think about capital targets in the current environment? As you know our capital target is 13.5 per cent based upon 12.5 per cent plus a roughly 1 per cent buffer. We have committed to paying down to that target over the course of the plan. So what that meant at the year end of 2021 is that we got to 14 per cent and because of some of the uncertainties in the environment we held it there. That gives you some idea of how we look at the capital ratio that we might hold to in the context of uncertain environment obviously taking into account any regulatory uncertainties that might accompany that. But the operating target, long-term operating target continues to be 13.5 per cent. The ambition is to pay down to that over the course of the plan. In the environment of uncertainty as it was at the end of 2021 we held it at 14 per cent and then we distributed everything above that. That gives you some context for the type of approach that we might adopt to this issue at the end of this year.

Aman Rakkar, Barclays
Thanks very much. In terms of RWA procyclicality that may or may not be coming down the pipe, is that another reason why perhaps you might print a pro forma CET1 ratio that is a bit higher than what we think otherwise?

William Chalmers
Well a couple of points on that perhaps. One is because as you know procyclicality relates to RWAs in the main. That is already going to be taken account of before we get to any given capital buffer which I know you will appreciate but just to make the point really.

Second point is the procyclicality of the business, to comment briefly upon that. We have a range of models within the business. So if you look at the mortgage model for example it is very much through the cycle. Albeit it is getting affected by some of the CRDIV discussions that we are having with the regulator and it is likely that we get a little bit more volatility in that going forward.

But essentially a through the cycle model. Second point, in terms of our unsecured, there is more point in time within the unsecured. We are going to see a bit more procyclicality in that if we do enter a macro downturn.

To give you some sense on the retail side. If we see a 10 per cent drop in HPI we are looking at around a £1.5 billion mortgage RWA increase. Now clearly that is not linear in terms of particular downturn scenarios but it gives you a sense as to what the expected RWA increase might be if we were to see a 10 per cent drop in HPI within the base case. Within commercial banking because we have a foundation on IRB approach it is very much through the cycle. That is to say we have regulatory prescribed loss given defaults. The RWAs don't typically budge much in the context of macroeconomic volatility. And you saw that during Covid where the RWAs did not increase terribly much. And we expect that to be the case pretty much going forward. So to be clear if the macroeconomic scenario deteriorates we will see some procyclicality. But you can tell by the comments that I have made that it should be relatively modest, not to say it is nothing but it should be relatively modest versus what it might otherwise be.

Finally coming back to the impact that all of that has upon capital distribution. The capital distribution question to be clear is very much a matter for the Board at the end of year. So I don't want to pre-judge that. But the RWA procyclicality will be taken into account by the time we get to those discussions with the Board.

Aman Rakkar, Barclays
Thank you, William.

Question 5 – Chris Cant, Autonomous
Good morning. Thanks for taking my questions. I wanted to come back to some of your comments on NIM and try to square the circle a little bit there. You talked about expecting tailwinds to continue to exceed headwinds going forwards and then I think in response to a later question you talked about tailwinds in frontloading more into 2022 and then headwinds being more pronounced next year. So are we to take it from those comments in the round that you are expecting NIM to sort of peak before Q1 and then start to get lower as we go through 2023? That will be the first question please.

And then coming back to the structural hedge, obviously we have had some years now of structural hedge growth. You talked about the buffer and potentially investing some of that in addition to continued deposit inflows in Q3. In fact very materially in terms of the size of the hedge verses pre-covid levels. Do you expect the structural hedge notional to continue to expand from here, or should we expect it to shrink in the coming year as customers start to modify their behaviour in respect of non interest earning deposit balances?

William Chalmers
Thanks for those questions. In terms of NIM, my observations around what happened in Q3, and what we expect to happen into Q4 as said very much remain along the lines of the tailwinds from bank base rate changes and the hedge effects outweighing the headwinds from the mortgage refinancing. Now making a call as to what happens in any sort of longer time frame if you like, very much depends upon what one assumes for bank base rate changes and what one assumes for mortgage spreads. What one assumes for frontward curve or front looking curves if you like i.e. the environment into which we deploy the hedge. You know these are big moving pieces and we have to see how they pan out during the course of 2023 and beyond before making too many calls around how exactly the NIM will develop. So all I can say is what we have seen within Q3 and what we expect to see in the near term future going forward, what we will see beyond that is really very much a function of the two or three variables that I just mentioned.

The structural hedge as you say, at the moment we have £250 billion in the structural hedge. We have seen a significant build up in buffer during that time from £9 billion as it was in 2019 to £31 billion as we stand today. The effect of that, or rather the impact of that, has been led by the over £70 billion in deposit growth that we have seen during that time, of which we have deployed about £40 billion into the hedge, by a further roughly £17 billion of increased eligibility principally in the commercial area the deposits that are now on a managed rate and therefore eligible for structural hedge. And then finally previously buffer deposits have now become very much part of the core franchise and therefore again are eligible for the structural hedge. And that has what has led to the increase to £31 billion in the buffer.

When we look forward we will take a view as to how much of that £31 billion might be assumed into the structural hedge going forward. But to the question you raised there we will look closely at how deposits behave within that. A couple of points on that. One is as you have seen we experience very positive deposit behaviour in Q3. So up £6.1 billion during the quarter, £2.3 billion increase in PCA's, £3.5 billion increase in CB. That is a very strong quarter of deposit growth and so the business continues to attract deposits in a sustained way. Of course as we get into a higher inflationary environment and a tougher macro, one might expect that to adjust gradually in the context of that tougher macro. But for now at least it has been a really strong quarter and has lent further resilience if you like to the structural hedge.

The second point within deposit behaviour is are we seeing a switch between instant access sight deposits into term deposits, i.e. stuff that would be no longer eligible for the structural hedge, might that affect it? And, so far at least, the evidence has been remarkably solid and consistent. That is to say, you can see from our disclosures, that current accounts for example are remaining very steady, in fact they are growing in line with my comments earlier on. The savings balances are remaining very steady, particularly if you look at our relationships savings balances, they are basically flat. There has been a little bit less activity in tactical savings balances but simply a function of pricing behaviour. So there has not been a switch from sight into term in a way that would question the structural hedge approach at all so far. Now clearly that might change as rates go high. One might, one would expect frankly, people to gradually put more of their money into term deposits. But again that is where the buffer comes in. I don't think we see £31 billion as a long-term buffer for structural hedge. It seems unnecessarily high. That presents an opportunity to us to consider a part of that £31 billion for the structural hedge as we go forward. How much of that we will consider appropriate will in turn depend upon how we observe some of these deposit behaviours that I just mentioned. But so far the deposit behaviours have been you know very reassuring from our perspective.

Chris Cant, Autonomous

Okay. Thank you.

Question 6 – Jonathan Pierce. Numis

Hello, thanks for taking my questions. The first one I just want to clarify something on this risk weighted asset pro cyclicality point because it is a question that is getting asked a lot more given the potential outlook for house prices. The £1.5 billion increase that you talked to just then is circa 3-4 per cent of your mortgage risk weighted assets in total which seems like quite a small number relative to a 10 per cent house price drop. Can I just check my understanding that this is basically because you like other banks I guess are assuming a downturn LGD in the models already that assume house prices drop effectively 25-40 per cent from their peak as I think is guided by the PRA. So I just want to check that is why the pro cyclicality as it directly relates to HPI and is so limited?

And the second question is on the capital guidance for the full year. I suppose the range is quite wide, 25 basis points with only a quarter to go, and I am just wondering whether this is largely a function of a decision still to be made with regards to dividend upstream from Scottish Widows. So I just want to ask on that has any of the recent market volatility that we have seen changed the potential for probably quite a sizable upstream from Scottish Widows for the full year? Thanks.

William Chalmers

Thanks, Jonathan. On the first of the two questions, the RWA pro cyclicality within the mortgage models. As said 10 per cent drop in HPI leads to a £1.5 billion mortgage RWA increase. Again just note the comment, that is a base case comment, as you move into progressively worse, or for that matter better, economic scenarios, it is non-linear in relationship to that.

In terms of the downturn LGD, yes I think we and others have it on a downturn setting if you like. And that does moderate the procyclicality of RWA's. But also I have made a couple of other points which are important to bear in mind is the quality of the mortgage portfolio which again contributes to relatively more limited RWA inflation. So as you know the mortgage portfolio is 40.3 per cent average LTV. Very low average LTVs. The amount that is in excess of 90 per cent is just 0.5 per cent of the book. And those customers with the significant income shock from that change in refinancing rates, even lower. So I think it is just worth bearing in mind also the quality of the mortgage book in turn helps on the loss given default which in turn supports the absence or relative lesser pro cyclicality versus what might otherwise be the case.

The capital point, your second point. The range that we set 225-250 basis points, there is not supposed to be anything particularly significant to read into that other than just us wanting to be appropriately prudent if you like as we give you guidance towards the year end. The business has generated around 52 basis points of capital in Q3. I don't see the trends in Q4, at the moment at least, as being terribly different to that. But as always there is going to be a certain amount of tying things up towards the end of the quarter which we will have to take account of. But that is not meant to hide anything particularly significant. We would see the run rate in Q4 as not too dissimilar to the run rate in Q3.

Your comment on SW. Scottish Widows as you know has paid a dividend up of about £300 million as of HY. The interest rate changes that we have seen have benefitted Scottish Widows from a capital point of view. Albeit there will be a transitional pre-calculation likely off the back of interest rate rises which will offset some of that capital benefit. I think if you take that on balance we are likely to see a H2 dividend on Scottish Widows. I don't want to pre-empt the Board at Scottish Widows about what that would be. But it is likely to have benefited somewhat from the interest rate rises that we have seen. We will take steps to ensure that Scottish Widows are as well positioned as possible to dividend up whatever it feels comfortable with in the context of the operating structure of Widows, the liquidity within Widows, protection of its own policy holders and so forth. But you know we certainly fully look forward to discussing the H2 dividend with the Widows board at the appropriate time.

Jonathan Pierce. Numis

Okay, thanks a lot.

Question 7 – Raul Sinha, JP Morgan
I have got a few questions please. Just, I don't know if you can take them in turn but just coming back to your comments around the capital distributions at full year and the 14 per cent. I was just interested in obviously your Pillar 2A went down by 50 basis points to 1.5 per cent. And in fact put that against your MDA and capital requirements. Obviously that feels like a step down from where you were previously. So just to try and understand is that reduction in Pillar 2A something that you perhaps already anticipating given the increased pension contributions and is it something kind of, business as usual in terms of the capital planning or is there something else that might be driving that? So that is the first question.

The second one, I am just interested in the increase in the Stage 2 balances in your mortgage book, £10 billion in the quarter, and I was just wondering if you can give us some perhaps qualitative comments around the interest rate shock that your mortgage customers might be facing? There was obviously a large cohort of borrowers two years ago around the help to buy scheme which might have locked themselves into unfavourable market conditions. And I was just trying to understand how you see your own mortgage customers behaving as their mortgage prices reset higher, what are you seeing in terms of affordability trends, and is that one of the reasons why we are seeing this increase in the Stage 2 balances?

William Chalmers
Thank you Raul. Just to deal, as you suggest, with each of those in turn. As you point out we have seen a Pillar 2A decrease during the course of recent weeks actually. At the moment our capital ratio, or capital targets, stay very much the same. That is to say the 12.5 per cent plus the 1 per cent is a capital target that we adhere to. When we look to our distribution decisions at the end of the year, which I said early on is really very much a matter for the Board, we will look at a number of variables within that and make an assessment as to where that stands. So that will include, clearly, the macroeconomic outlook number one. It will also include regulatory uncertainties. Don't forget the countercyclical buffer, for example, is coming in tail end of this year and into next. And also will include our ACF performance for example which is in the second half of this year as well as any changes within the anticipated Basel 3.1 although as I said before we see ourselves as net neutral on Basel 3.1. So we take account of the macro outlook if you like, good or challenging. We will take account of the regulatory benefits and seeing e.g. Pillar 2A as well as some of the regulatory uncertainties. We will also take account of the business performance and all of that will then lead to a Board discussion about what the appropriate distribution is at the end of the year. So those facts are very much taken in the round.

Your second question on interest rate shock, and in particular Stage 2. As you say we have seen an increase in Stage 2 since June. The mortgage component of that, I think you mentioned a number of £10 billion. We have actually seen Stage 2 in totality increase by about £15 billion since June. And that is very much a function of the change in economic outlook, the multiple economic scenarios that I talked about a lot in my script earlier on. A testimony to that, you have seen a significant increase in up-to-date Stage 2 versus what it was in June. So at June, 90.5 per cent of our Stage 2 was up-to-date. As we stand today 92.5 per cent of our Stage 2 is up-to-date. And that accounts for the vast majority of assets that have been transferred into Stage 2. So the vast majority of assets into Stage 2 post June are up-to-date and therefore high quality assets. Further testimony to that we have seen Stage 3 remain static, so if you look at Stage 3 in Q2, sorry actually in Q1, in Q2, in Q3 they are staying around £11.4 billion. It is not moving and that goes back to my earlier comments on a) the strength of observed credit quality that we have seen which has led to the £250 million charge. And b) the influence of, not just the economic outlook, but particularly the severe scenario that we portray in terms of the additional £600 million MES charge that we have taken. £250 million of that £600 million MES charge is coming from the 10 per cent weighting attached to the severe economic scenario. So you know don't forget that is what is going on in our impairment charge, it is about those scenarios and it is significantly impacted by the severity of the severe downside scenario.

To answer your question on mortgage a little further. For the mortgage assets that we have we have tested for many years now on the basis of SVR plus 3 per cent as a stress test to apply to borrowers. That SVR plus 3 per cent, for many years now, has been well in excess of the type of 6 per cent refinancing rates that customers are likely to see during the course of 2022, the remainder of 2022, and into 2023. So we have effectively stress tested customers for rates in excess of what they are going to refinance onto. Added to that most of our customers, although we take a relatively broad cut of the demographic on our liability side and our savings and deposit side, we tend to lend in to relatively better off customer segments on the asset side. A testimony to that, the average household income from mortgage borrowers is £75,000. That means that they are able to afford the type of rate environment that we are moving into now. And again our stress tests have indicated that, supported that in terms of the original lending positions.

When we look at those customers who are likely to experience significant payment shocks. Those customers who are likely to experience significant payment shocks, we think, are in a relatively small group. And those customers are at higher LTVs and likely to experience significant payment shocks are a very, very small group of the portfolio. And the best evidence of that again is our loan to value ratios for the portfolio as a whole at 40.3 per cent, and for those customers in excess of 90 per cent of less than 0.5 per cent. So hopefully that gives you some idea for how we look at the mortgage issue.

Raul Sinha, JP Morgan
Thanks very much.

Question 8 – Omar Keenan, Credit Suisse
Good morning, William. Thank you very much for taking the questions and thank you for the colour around the severe downside scenario assumption. Can hear you that these are quite conservative and it does also look to me like base case is more cautious than the current consensus. So it does feel like you are getting ahead of things which I think feels very sensible. But I just wanted to explore a little bit the circumstance in which the economic environment gets a bit worse from here and how the provisions should behave going forward from here. So if I look at your new downside scenario that has got GDP of -2.3 per cent, unemployment peak at 7.5 per cent, and house prices falling 22 per cent, which feels like a sort of a reasonable further downside case which is bearish but it is not a kind of Armageddon scenario. Slide 19 seems to imply that would be an additional £500 million of provisions which is around 11 basis points of loan. So if we were to think about that playing out in 2023 should we think about a possible asset quality ratio of in the 41 basis point range to account for that? Am I thinking about that correctly or am I not? And could you just help us a little bit with how the management judgements have changed as well please? Thank you.

William Chalmers
Thank you, Omar. As said our intention with respect to the economics and the impairment charge that comes off the back of our advised economic base and associated scenarios, it is very much to address what we have seen over the course of the last quarter and take into account the world as we saw it at the end of September. In a way it is consistent with the requirements of IFRS 9. So I think most people would acknowledge that, so there have been some modest deterioration in the outlook from the end of Q2 i.e. H1 to September 30th. I think most people will acknowledge that and the approach that we have taken for the base case in the MES is simply to recognise that and put it into place. Now as you can see from our assumptions therefore looking forward it is a reasonably conservative view of how it might play out it forecasts a modest downturn i.e. recession in 2023. The forecast is an uptick in unemployment, around 5.5 per cent. And there is a softening of house prices of around 8 per cent, peak to trough of around 10 per cent.

Those are the factors that contribute to the base. The base expected credit loss associated with that is around £4.35 billion and you can see that on page 19 that you referred to. The impairment charge that we have taken for Q3 as I mentioned earlier on is impacted clearly by that change in the base case but it is also impacted significantly by the change in the downside and in particular the change in the severe downside. The severe downside has moved from £6.8 billion at HY to now £9.4 billion and as a result we have taken a 10 per cent share of that increase of £2.5 billion. And so £250 million therefore of the impairment charge is driven by that severe downside weighting. Now that is not, as I said in my script, that is not what we expect to happen, but that is driving the element of the impairment charge as of Q3.

What that means in response to your question is that what the AQR will look like as of 2023, I won't give guidance to you on 2023 now, but absent any MES changes, you should simply see the roll forward of the book on an observed asset quality basis. And as I mentioned before, the Stage 1 rolling forward on a twelve month basis every three months. So that is what you should see, absent MES changes. If there are MES changes of any description, it is worth just bearing in mind that it won't just depend upon the base case but it will depend upon how also the downside case and the severe downside case respond. And that is particularly important right now because if you look at the difference between our base case expected credit loss, the £4.35 billion number that I mentioned earlier on, and the actual ECL that we are holding of £5 billion, there is a £700 million buffer there.

And so in answer to your question of what is the AQR for 2023, even if we get a change in outlook the actual impact upon AQR and expected credit loss will very much depend upon how the downside and the severe downside respond to that. And as said as we stand at the end of Q3 there is quite a big buffer between the base case expected credit loss and the actual expected credit loss for the holding of the balance sheet. That gives you a bit of sense for how you might look at your question Omar.

Omar Keenan, Credit Suisse
Okay, thank you very much. And just the current position on management adjustments?

William Chalmers

Sorry, Omar, I forgot to comment on that. The management adjustments have come in quite a lot since HY. So at the moment the Covid management adjustment, as you know, we released £200 million into Q3 results. That is standing at just below £100 million, number one. Number two, the inflation adjustments that we have seen, they have come down a little too, we are holding around £130 million of inflationary adjustments. Why have they come down? They have come down simply because the inflation and the interest rate environment within our base case, but also within our downside and severe downside, is now incorporating higher interest rates, is now incorporating higher inflation. And so as a result, we are able to measure within our models the extent to which those higher interest rates and higher inflation rates impact the behaviour of the portfolio and the extent to which they will feed through to the expected credit loss. And so effectively, what was previously a management judgement at H1 have now been assimilated within the models as of Q3 very largely. There is still an inflation adjustment, and that inflation adjustment is targeted at a real versus nominal income adjustment, which you may remember me talking about at Q2. And also at vulnerable customers who are typically the more indebted customers. Number two, which again I think I talked about in Q2. Those two pieces are remaining but much of the rest of the management judgement for inflationary times have now been assimilated into a model which projects higher inflation, higher interest rates.

Omar Keenan, Credit Suisse

Okay that is very helpful. Thank you.

END

FORWARD LOOKING STATEMENTS

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