LLOYDS BANKING GROUP PLC - Q3 2022 IMS - SELLSIDE ROUNDTABLE TRANSCRIPT
(amended in places to improve readability only)

Monday 31 October 2022 – 4.00pm

LBG:
William Chalmer, Chief Financial Officer

William Chalmers
Thank you to everybody for joining this afternoon. I think we gave a few introductory comments in the call, by way of my script and then the presentation, on Thursday of last week. So rather than have me repeat too much of that it might make sense just to go straight into Q&A. So thanks again very much indeed for joining. Happy to take any questions in the order that they arrive.

Question 1 – Rohith Chandra-Rajan, Bank of America
Thank you very much. I have three things I just wanted to get your insight on please. Hopefully all relatively quick. The first one was your comments around deposit pass through. I think you mentioned they were so far in line with the sector. I think that is in the high twenties. So I just wanted to check that your interest bearing deposit pass through has to date been in the high twenties? And then the 50 per cent pass through embedded in the rate sensitivity disclosure; is it appropriate to use that for future rate hikes or when you talk about the 50 per cent is that from the 10 basis points up to wherever we end up. So is it from here or is it through the cycle, that 50 per cent pass through?

And then on the mortgage spread, again you talked about relatively low spreads I guess late Q3 early Q4. I just wanted to clarify when that really comes through to the P&L. I would have thought it is mainly a Q1 next year issue, with a bit in Q4, but just curious on timing there.

And then the final question was IFRS 17. I know you are going to give more detail at the full year, but is the indication that you gave this time last year still a decent working assumption, please?

William Chalmers
Thanks for those questions. Just to take each of them in turn. I think the overall sector pass through on deposits has been somewhere in the 20-30 per cent range, or thereabouts, year to date since base rates started to rise. I won’t comment specifically on exactly where we are, safe to say that I think we are more or less in line with the sector which hopefully is helpful. As said when we look at the determinants of that pass through we look at the three points that you have heard me mention before in terms of offering value to customers, offering a competitive response and making sure that we pay attention to the funding fed into the balance sheet which as you know looks pretty liquid at the moment off the back of a low LDR range.

I think the further point that I would add on that question is that we do expect this pass through to build as time goes forward and as base rates increase. And so, and it’s linked in a sense to your second question, but as we see base rates increase kind of at or above the levels that they are today, so our expectation is that pass through will increase in line with that and converge towards the 50 per cent assumption that we make. Conceivably there may be points depending on where base rates go, it goes, above that, I don’t know, I am not really forecasting it as such, I am just not ruling it out on the other hand either, but I think converging up to the 50 per cent as base rates rise is a reasonable assumption, at least a planning assumption as it were.

So to your second question. The point at which 50 per cent becomes valid. I will answer your question, but you will have to tell me whether or not it addresses the point. Which is to say that when we look at that sensitivity that is using the 50 per cent assumed from the point at which the main base rate change is made together with the curve change alongside of it, parallel shifting curves. And so that point for the purpose of sensitivities, £150 million, 25 basis points, that is the point to which the 50 per cent kicks in. So when I have finished that, Rohith, tell me whether that answers your question or not.

On your third question, mortgage spread, when does that come through? It is an interesting point because essentially a lot of the business that we wrote during the course of July and August, as you heard on Thursday, was at pretty favourable application and completion margins. We then wrote a lot of business in the tail end of September, when the volatility release started, and because of swap price moves was relatively narrow margins, but we wrote quite a lot of it. There were a lot of people at that time looking to refix. And so that business will come through largely into Q4 actually, and you will see our completion margins in Q4 will reflect the volume of that business that was written in the tail end of Q3 will complete into Q4 and will be a factor in Q4 completion margins. I think what that means is that actually as you look at what is going on in the market in Q4 in terms of application margins at that point, it will be a somewhat familiar story I suspect of application margins being ahead of completion, at least as reported in Q4, because Q4 will have been impacted by the volumes at the tail end of September. And when does that come through into P&L, which maybe what you are getting at, that is clearly then coming through into P&L basically in Q1 next year. And so you will see the completion margin effectively being reported in Q4, which will reflect some of that late Q3 business, particularly in the last week or so of September, you will then see that entering the P&L essentially from Q1 onwards in 2023. So that is the kind of evolution if you like of that pattern.

The fourth question around IFRS 17. Broadly speaking the comments that we made about a year ago hold true, I think it was Q3 2021, where we talked about the IFRS 17 impact, and talked there about a couple of different attributes. One is that IFRS17 essentially spreads the benefits of new business over the term of the product rather than accruing for it on day one in the way that IFRS4 does. Two is that despite that it makes no difference to the underlying cash flows, the dividends from the insurance company into group. And three is therefore it makes no difference to either the distribution potential of the group or alternatively the capital position of the group. It is an accounting change. So the only point that I would just highlight I guess which we mentioned in Q3 2021 and I just underline it again is that as you know at the end of the year we have something called an annual basis review for assumptions within insurance. And so in addition to any effect upon the spreading of new business and other things like deferred acquisition costs and aspects like that, all of which you know very much is in line with where we were last year. You also see assumptions getting spread over a similar timeframe. That is to say if you have a change to an expenses input for a set of products if you like, rather than accruing that all on day one under IFRS 4, you are spreading that over the lifetime. And so the effect of IFRS 17 into 2023 insurance earnings as compared to what exactly the same set of earnings would have looked like were they to have occurred in 2022 is a function of operating income and new business is also a function of assumption changes through the AVR which, as said, is typically a Q4 for event for us. The final point on IFRS 17 as with any accounting change there is some kind of day one effect if you like for reconciliation of accounts. I shan't go into those now simply because they are being worked on as we speak. But with any restatement under IFRS 8 you are going to see some effects which will not affect capital, will not affect any of the cash flows that are obviously important to shareholders and you as analysts, but there will be IFRS 8 type changes in transition statements which we'll be reporting on in the first quarter of next year.

Rohith Chandra-Rajan:
Thanks, William. So the mortgage question, yes it was about the P&L so that is helpful, thank you. And then on the deposit pass through, the sensitivity table that you show assumes a 50 per cent pass through on all future rate rises. My question was when you think about 50 per cent is it across the full range of rate rises, so as we have increased from 10 basis points to wherever we get through, or is it, and I think this was your answer but just wanted to confirm, that pass through to date has been somewhere around 30 per cent, maybe a little bit less for the sector, and you expect pass through to increase to up to 50 per cent for future rate rises. Is that what you are indicating?

William Chalmers
Yes I think that is exactly right. So for the sake of clarity, what we are seeing to date since base rates started to rise at the beginning of this year is pass throughs in the sector in the range that I indicated, 20-30 per cent. That is viewed as a whole, you will get more in some rate rises, or more base rate rises, and less in others. So it not being kind of equal it is kind of aggregating the whole thing as seen 20-30 per cent over the year as a whole. It is also not being totally equal between sectors either. You will have seen in some cases more in retail and in other cases more in commercial. But viewed as a whole the sector has moved about 20-30 per cent year to date. We have ourselves moved more or less in line with the sector within that range. And so we are kind of there. When we show the sensitivity it is not catch up the 50 per cent as it were it is simply the 50 per cent is used for illustration on that chart. And then finally when we look forward we are, my expectation, is that people will start to pass on more as base rates get higher because I think deposit sensitivity will get greater as base rates gets higher and therefore institutions to be competitive and look after their customers will I think pass on more like the 50 per cent used in the illustration versus the 20-30 per cent to date. It could be that in some niche areas institutions pass on a little more than that, I don't know. It is not, as I say, that is not my forecast as such but I wouldn't necessarily rule it out. But the point is that at the moment we are well south of 50 per cent. I think as base rates go up we will converge towards 50 per cent and we use 50 per cent by way of illustration in our sensitivities.

Rohith Chandra-Rajan
Okay, thank you very much.

William Chalmers
Thanks Rohith.

Question 2 – Omar Keenan, Credit Suisse
Good afternoon, thank you very much for making the time. I have got two questions if I may. The first question is on mortgage margins. I was wondering what you thought about the level of risk premium that might have come into the current level of mortgage rates? I just noticed that swap rates have looked to have retraced back to where they were before 22 September. And so on the face of it, it does look like application margins have expanded compared to where

they were then. Could we think that maybe over the next couple of weeks mortgage rates are likely to come down if swap rates kind of are where they are or do you think that the kind of shift in the risk premium with the market?

My second question is on operating costs. I know you have made a couple of questions about managing efficiency versus inflation. Is there anything you can tell us around what is currently being considered around the moving parts on the efficiency measures, the saving of those investments, and what salary inflation is likely to be? Thank you.

William Chalmers
Thank you. I will just kick off on the first of your two questions, mortgage margins. I think the mortgage margins, as you know very well, have significantly moved around over the course of this year in response to swap rates effectively front running pricing changes by some way. And therefore the determination of what is an equilibrium mortgage margin has not always been easy to tell frankly. We saw that over H1, we saw that again in Q3 particularly towards the end of it as just discussed. And so what is a stable equilibrium mortgage margin is a little difficult to tell. Now, as your comments point out, that just got a little bit harder because we are now entering an environment where the macros are a little bit more adverse and therefore the risk adjusted return needs to take that into account. And I think most providers would look at risk adjusted returns in terms of their pricing of mortgages.

A couple of points having said that. I think some of the reasons why you are seeing, so far at least, limited moves in mortgage pricing is independent of the risk factors. Is effectively just a reassertion of some level of rational pricings within the market. You saw pricing, or rather margins, get effectively very irrational at the end of September. You then saw some pricing up from players who now want to see a period of swap stability before they necessarily price down in order to re-establish what is, again independent of risk factors, a rational margin for the book. I think that is point one.

I think then point two where that rational margin lands will take account of risk adjusted margins, and the macro is changing, therefore the risk adjusted margin has to change with it. There will be a degree of that. Now having said that many lenders, including ourselves, will already be factoring in significant risk adjustment over the course of the cycle for which their mortgage is granted. When we grant a mortgage, as you know, we take account of the pricing and the securities in the mortgage through the cycle. We stress our customers in total, so we are taking account of how the mortgage might form over the expected longevity if you like or duration of that mortgage while it is outstanding. And we recognise the macroeconomic conditions might change during that time. So we are taking account of some factors there. But I think that notwithstanding historically has been the case that margins have tended to widen and macroeconomic conditions have toughened. And that is a phenomenon that I would expect to repeat itself in the market as a general matter going forward, leaving aside what we might do as an institution, I think the market has done that before and it is quite likely to do that again.

A third point which is worth bearing in mind here is the relationship with the liability side of the balance sheet and we have been encouraging the market as a whole to very much look at returns and the margin on a holistic basis. And so what happens with mortgage margins will also be a reflection of what happens with deposit margins. And typically at least the wider deposit margins get the more comfortable people feel being a little bit more aggressive on the mortgage side. And there is a degree of I suppose interchange between those two. Deposit margin, or rather the liability margin and the asset margin do move inversely with each other from time to time. And so as we look at mortgage margins going forward worth bearing in mind.

And the final point which I think comes back to your risk adjusted or your risk premium point here is that we and all other institutions are looking to earn sustainable returns as a business. And so pricing across the board but including mortgages will look to take that into account which I think is simply another way of attacking the issue on risk premium that you were mentioning earlier on. So there are some thoughts on the mortgage pricing.

On operating costs perhaps just repeat the question to make sure I understood the question if you wouldn’t mind Omar?

Omar Keenan
Yes of course, thank you. So on operating costs, so I guess under the original strategic plan that was set out at the start of the year, operating costs are expected to be flat through to 2024. But obviously I guess one would imagine that with interest rates a lot higher, you know there is more impact from inflation as well. And so is there any indication that you could give around the level of wage inflation that could come through next year? And what possibilities there are to maybe accelerate efficiency plans so we can think about how the moving parts for 2023 are changing versus what they might have been in February?

William Chalmers
Sure, thanks Omar. I guess a couple of points to make really. One is just to reaffirm the cost guidance that we have given for 2022 at £8.8 billion. As said last Thursday we intend to deliver on the £8.8 billion in 2022 and that is very clear. When we look forward, the February discussion that we had, as you know the targets were pre-all of this inflationary pressure that we have seen since

then. A couple of points to make to that. One is just to say that we have seen significant inflation since those February targets were set. Two is that we still aim to deliver the £1 billion in savings in the plan that we promised for the periods to the 2024 year and thereafter. So that commitment both in terms of BAU and also the savings funded off of strategic investments, remain the same. The third point is that we are not giving 2023 guidance at this point as normally it is with us and as I am sure you would expect we will not be giving 2023 guidance. But we are looking at the 2023 plans now as we speak. What I think you can draw some comfort from is that the cost discipline that we have and have proven time and again if you like, will remain. But at the same time we are not immune to be clear from the inflationary pressures that we are seeing. Where are those coming from? They are coming from things like OPEX for example. They are coming from things like supplier relationships for example. And they are coming as to your question around wages. I am not going to comment on the specific wage number simply because we are right in the middle of our negotiations with the unions right now. And so I am not going to get drawn into percentages for fear of impeding those discussions. But as we look at those pressures we are able to accommodate some of them.

So for example we have long term contracts with suppliers. We have matrix management which has been proven to be very effective. We have forward of purchase agreements with energy suppliers for example, all of which help with consultancies, with our own internal resources and with the case, as I just said, of energy supply. Plus also we have some allowance in our budgets that we clearly made when we talked to you in February about expectations for increasing compensation costs going forward. But having said that, the inflationary pressures that we have seen since 24 February have exceeded our expectations in those budgets. What that means we are as I say taking a look at now, we will be updating you on that at the year end and come back to you on those numbers.

One point that I made in my script on Thursday which is perhaps just worth underlining is that next year, as always planned, is our peak year of investment or rather will be our peak year of investment. So that is just worth bearing in mind, that is a further factor, it was always planned but one that is worth further commenting on. Final comment on this is, it won’t surprise you, our expectation that the income benefits that we have seen over the course of the last year or so significantly exceed any cost pressure that we will be seeing above and beyond what we anticipated on 24 February.

Omar Keenan
That is great, thank you very much.

William Chalmers
Thanks Omar.

Question 3 – Fahed Kunwar, Redburn
Hi William, thanks for taking the questions and thanks for the answers so far. I had a couple of questions. One was just on the consumer credit coverage ratios. Obviously they will pick up a little bit after your provision increase. I was just wondering on a like-for-like write off policy basis, I know your write off is a bit more aggressive than perhaps your peers. With the 4.6 per cent credit card coverage ratio or the kind of 5 per cent consumer credit coverage ratio ex-auto which is lower on a headline basis, if you were to adjust for a 12 month write off policy, what would that coverage ratio be would be the first question.

And then the second question was just a follow-up on the deposit beta questions. When you, I guess in the answer is a bit of both, but just some colour around the assumptions on rising deposit beta, is that you kind of passing on more of the interest rate to instant access accounts or is that a shift of time deposits that you are factoring in to rising deposit beta? And the second part of that question would be any sense of the differences in deposit beta of kind of businesses versus households would be very helpful. Thank you.

Answer – William Chalmers
Thanks Fahed. I might just check one or two points on the second question, but I will come back to that in a second. On your first question around consumer credit coverage. It won’t surprise you to hear me say that we feel extremely comfortable actually in the coverage of the book. In fact having taken the forward looking provision that we have taken as I mentioned on Thursday in particular because of the anchoring effect of the severe downside scenario. We feel very well covered for all of the scenarios that we look at going forward, you know be it our weighting of 30 per cent downside, 10 per cent severe. So we feel very well covered for our base case. I gave by way of illustration on that point the fact that the ECL for our base case is looking forward £4.35 billion, but our ECL in terms of what we have on the balance sheet is over £5 billion. So, there is £700 million more than we expect to need in our base case currently on the balance sheet.

So the specifics of your question, entirely fair question, look at the cards piece which is where I will answer it for you. If you look at the cards piece, we essentially write off, or charge off, within 4 months. I think our competitors typically charge off within 12 months. If you adjust for that we are covered greater than 70 per cent. And that’s a level that we feel very comfortable with because typically the recoveries that we see have been in excess of 30 per cent. And so as a result we feel the combination of that charge off policy plus the recoveries that we typically see leads us to, or allows us if you like, to more than cover the exposure.

I was simply going to say that every now and then, including in Q1 of this year, we undertake debt sales which give us further if you like test of relief to the views of the market on the same points that we take our own internal views on. And typically we achieve NPV positive values, in fact all the ones that I have ever signed up on we achieve NPV positive values on the debt sales meaning the market is prepared to pay us more than we hold on our balance sheet.

Fahed Kunwar
That's very helpful. When you say 70 per cent coverage I assume you mean on Stage 3 card balances, your coverage would go to 70 per cent.

William Chalmers
Yes, so the coverage of Stage 3 in cards as you know is about 54.5 per cent or thereabouts. And that is exactly as you just said.

Fahed Kunwar
Brilliant, thank you.

William Chalmers
In terms of the deposit beta, I think your question was, I will just check this perhaps if I could. The question was as we look forward is the move back to 50 per cent a result of greater pass on for the accounts that exist in the form in which they exist today or is it a function of instant access gradually shifting into a different deposit format.

Well just on that I think there is likely to be a combination of both. The overall 50 per cent assumption that we are making is basically across the variable rate book. That is, I should perhaps make the point, across both the retail and the commercial components of variable rate book which, as you will have heard me say before, is somewhere between £200-250 billion. I don't think we actually disclose the exact number, but it is in that space. And the 50 per cent is used as an aggregate across all of those accounts. I think it is very likely that we will see some shift out of instant access and into time deposits. And that will gradually increase in terms of volume as we move into higher rate environment. That in itself will obviously reduce the overall sensitivity that we see from interest rate changes, or base rate changes I should say, going forward. And then within those deposits that we have, the variable rate deposits, I think there will also be an element of us passing on a greater share moving towards that 50 per cent going forward. So the two effects will be as accounts/deposits move out of instant access and into time, because they're term, they will effectively come out of the variable sensitivities that we can show i.e. they will reduce again that £200-250 billion that I mentioned. At the same time we will probably pass on a greater share of those as we move forward to a higher rate environment.

Fahed Kunwar
That's very helpful, thank you. And could I sneak in one quick follow-up. If the mix went back to the pre GFC days, and by mix I mean between interest free or current accounts and time deposits, would your structural hedge be the appropriate size still or would it need to be smaller? I am not saying it will go back to that, but if it was to go back to the pre GFC mix days with the last time we had savings rates this high, would your hedge be at the appropriate size?

William Chalmers
It is a fair question. We have been looking at that a fair bit lately. I think we draw an awful lot of comfort frankly from the size of the hedge we have, size of the buffer that we have, the potential customer responses that we might see. I think people's behaviours have also changed quite a bit since before the GFC. As you know very well, we are in a world where the unimaginable seems to be happening every second day, and therefore precautionary behaviour is very different now to what it was before the GFC. The same thing could be said for financial institutions. That is to say the strength of the incumbents as effectively franchises that protect their depositors, and the stability associated with those, it is much better than it was pre-GFC where frankly people were prepared to put money more or less anywhere. And so behaviours have changed, the perception of where you might want to put your money has changed. It is hard to say categorically what would happen if we were to go back to pre-GFC circumstances, because those baselines have changed so significantly since then. I do think as we go into a higher rate environment we have to be careful about how we manage the structural hedge because of deposit flows. And indeed that is what we think we are being by virtue of the buffer build ups that we have seen. And also as you can see at the moment that these kind of deposit flows really vindicates the strength of franchise, for example the growth that we saw in Q3 rather than indicate any concerns about stuff moving into less structural hedge friendly or less structural hedge eligible forms.

Fahed Kunwar
That's grand, thank you so much for the colour, cheers.

William Chalmers
Thank you Fahed.

Question 4 – Guy Stebbings, Exane BNP
Afternoon, thanks for hosting the call. The first question is on pensions. I appreciate that you don't tend to give much detail on pension scheme around a Q1 or Q3 results. But it has obviously been a very volatile backdrop of late for inputs in the pension scheme, valuation of the assets, liabilities with various competing dynamics in terms of how they might impact the position of the pension scheme. I imagine if we were talking around H1 results you would have been quite confident that the actuarial position of the scheme would have improved, just given the deficit contributions, the rising discount rates. Just wondering is that still the case, should we expect that and so any colour around how we should be thinking about the pension scheme where that is going to land at the full year obviously ahead of the triennial next year.

And then the second question was on deposits, and sort of plays into some of the discussion around deposit betas and structural hedge assumptions, but I just wondered if there any disclosures around age profile deposits you might be able to share. I presume it is something you must look at internally when you think about stickiness of deposits and how they might evolve in the future. Anything you can share around sort of customer demographics, and would it be fair to assume that older customers might make up a larger share of what you deem rate insensitive sticky deposits, or does it not really work like that? Thank you.

William Chalmers
Thanks Guy, happy to address those. We are happy to give an answer around the second one which shall give you a sense of direction on these points. And then happy to comment on the first.

The pensions point first of all, the start point there as you know is £7.3 billion actuarial deficit in 2019. Since then we have made a £1 billion contribution in 2020, a further £1 billion in 2021. And then as you know through a combination of fixed and variable contributions this year, a further £2 billion. So that is £4 billion off the £7.3 which gets us back to £3.3 billion kind of standing start. Now on top of that, despite obviously some tougher markets this year, the asset performance over the term has been generally pretty favourable. So there have been some benefits from asset performance within, or rather in addition to, those numbers that I just mentioned. And then we have also seen some rates move. Now to be clear, as rates have moved up we have locked in part of that benefit over time because we did not want to be in a position whereby if rates fell all of a sudden that actuarial benefit that we are receiving from higher rates eroded with it and so we did lock some in. But not all of it. And so as a result we have shared, or rather we have benefited somewhat, from the rate rises that we have seen. At the same time it is not a one to one simply because we have locked some in by hedging along the way. What all of that means is that a combination of contributions number one, asset performance number two, and rates move number three, leaves us to think that by the year-end in the discussion with the trustees we are likely to see an actuarial deficit somewhere in the £2.5 billion type range. I won't be more precise than that because as you can imagine there are a number of uncertainties being ironed out. But that gives you an idea of where our expectations are right now. And we will look to report back to you on that at the Q4 results.

On the deposits, the deposits base is a pretty broad demographic first of all around I guess the customer base that we represent on the liability side. I have said before the asset side is actually quite skewed to, I suppose, a better off segment of society for want of a better word. But the liability spread is broader than that. Now having said that, it won't surprise you to know that the liabilities are at the same time somewhat skewed towards a more affluent democratic. So if you took a look at the overall spread of deposits, to your question, you would indeed see elements of deposits that are more concentrated in wealthier segments and in many cases older segments too. So you will see some concentration there. I guess the only point that I would make without being too precise about it is at the same time the skews are not as great as I assume at some of the financial institutions. They are definitely there, but it is not the case where you have, let's say, a very high percentage within a very small percentage of the overall customer base. Albeit there are some concentrations.

Guy Stebbings
That's really helpful on both points, thank you.

William Chalmers
Thanks Guy.

Question 5 – Aman Rakkar, Barclays
Good afternoon, thank you very much for all of the questions. Can I just ask one additional follow-up on costs to start. If you could just let us know roughly speaking what assumption rate you were making in February when you issued the cost guide of flattish next year. You know what assumption rate were you assuming for CPI in 2023 when you issued the flat cost guide for 2023.

The second question was around other operating income. I would just be interested for your updated view on what you think a kind of normalised run rate is for OOI and given another quarter of information but also I think maybe a shift in the operating outlook from where we discussed it previously. Thank you.

William Chalmers
Sure, again I may just ask some clarification on your second question. But on your first a couple of points that are worth making. On the cost guide that we gave previously on 24 February 2022. Cost guidance that we gave was for £8.8 billion in respect of 2022 which, as said, we will deliver on. And then £8.8 billion for 2024, not for 2023. So we had always envisioned, I mentioned the investment peak for example earlier on, but we had always envisioned that, if you like, having an intermediate effect on the shape of the costs while the investments peaked up, for then the effective cost savings number one, and strategic initiatives on the cost base number two, brought them back down to 2024. Now to be clear, we will be updating on 2023 cost guidance, and very much looks like at the moment 2024 cost guidance in line with our expectations, at the end of the year. So Q4 2022. But to recount what we said in February, it was in respect of 2022 and 2024. In terms of the CPI indication at that point, I don't have the presentation for my fingertips, but if you look at the presentation that we gave at that time on 24 February there would have been a base set of economics in there. It would have had CPI inflation for 2022 and looking forward into 2023 and 2024. And that would have been very largely the case on which we were forecasting inflation. And obviously there would have been some ups and downs within that, so wage inflation for example we struck a settlement, I think it was February last year, around 3.6 per cent with our employees for that round. But the overall CPI point would have been in those economic scenarios at the time. Low single digits would have been the answer, but again look back at that for the precise number.

On OOI Aman, can I just check your question was in respect of the remainder of 2022 and 2023 was it, before I get too far into your answer?

Aman Rakkar
Yeah to be honest with you, any colour that you can give us on your expectations for OOI, in 2023 I guess I was asking you, maybe in an unhelpful way. I think you talked about a kind of £1.2 billion underlying run rate for that number. Just kind of interested in how do you think about OOI in 2023?

William Chalmers
Thanks Aman. So looking at OOI, as you know I will repeat the point obviously, we are not giving guidance for any aspect of the numbers right now, whether it is income, cost and so forth. But nonetheless, when we look at 2022 as you say, we have got a run rate right now, actually I think it is probably a nudge above £1.22 billion, it is more like a £1.25 billion or thereabouts, quarter on quarter.

There is a couple of different things going on there. We have seen some benefits from higher levels of activity within the commercial banking business, for example. We have seen some continued levels of activity within retail building up through the year. And then some puts and takes within insurance. So, for example, some weakness in GI off the back of the STA reforms that we have seen. And a little bit of stepping back from price terms in bulks that we do not think there is value in. But at the same time some more encouraging trends, for example work place pensions in insurance and wealth. So some puts and takes there. And as we look forward I think broadly speaking we will see some similar trends, that is to say retail, we will see potentially activity levels being impacted by the macro. But on the other hand I would say there at the same time we think that, I made the comments on Thursday, that it is possible that we will see some unsecured balance growth off the back of the card base increasingly engaging in spending activities, which I don't think would necessarily be backed off on. I think the trends within CB will very much depend upon hopefully stable within corridors but nonetheless a little bit of volatility in markets allow our clients to initiate hedging activities for example, other corporate finance activity resuming. And then some benefits and continued benefits from insurance activity. So all of these things I think will just gradually consolidate going forward. I don't think it would be hugely significant in terms of the pace of progress, but I think gradually over time that will build up. That is then augmented by strategic initiatives coming more fully online both inorganic e.g. the Embark transaction, and organic, I have mentioned Citra, but then of course the strategy itself starting to be delivered on. Those strategic initiatives from the announcement in February, I think they will really take until 2024 before you really start to see some numbers emerge from those. On the other hand I think the combined effect of Citra and Embark will add somewhere between £50-75 million type numbers over the course of 2023 looking forward.

So I think overall, again without giving specific guidance for 2023 in OOI, you will see some continued pattern of activity which consolidates around that £1.25 billion type level, maybe a nudge above. And then I would hope you would see some benefits from the inorganic and organic initiatives that we have launched over the last year or so. And then finally two caveats to all of that. One is IFRS 17, we discussed it earlier on, has an effect upon new business, has an effect upon insurance assumptions, and therefore one needs to adjust for that. And then secondarily, these comments that I am making are really in the context of our base case economics, and so if the economics deteriorate, then of course the activity led benefits off the back of that will be impacted.

Aman Rakkar
Thanks William that is really helpful.

William Chalmers
Thanks Aman.

Question 6 – Chris Cant, Autonomous
Good afternoon, thanks for taking my questions. If I could just come back on costs I am just sort of keen to understand the moving parts within the cost base. So you talked about the £8.3 billion of BAU costs at the February update. Within that £8.3 billion can you give us a sense of how much of that cost base is either sort of fixed in effect, because it is accounting related, so depreciation, amortisation is obviously a function of historical spend and is not going to inflate because of CPI going up, or is sort of contractually tied in, I think you mentioned long term supplier contracts and things like that. So within the £8.3 billion BAU, how much can we sort of park to one side and say well that is not impacted by the CPI change. And in terms of the CPI change then on the rest of the £8.3 billion, if I look back at your assumptions you were pencilling in kind of compound CPI over the three years of the plan of just about 11 per cent and it is now about 19 per cent if I look at consensus. So should we be then taking that peak per cent differential and applying it to the other bit of the £8.3 billion when we are thinking about that 2024 cost number. Is that crudely how we should be thinking about it? It feels like a sensible way to come at it but I don't know whether there are other things, other sort of rabbits under your hat that you can pull out to offset some of that spiking inflation? That will be the first question, please.

And then on IFRS 17, helpful to I guess reiterate the commentary around what you said a year ago which I think was £400 million impact on other income and about a £100 million benefit to the cost line. In terms of the TNAV hit, you guided to 5p and I guess I am a little bit surprised that you said that is still the right number, I would have thought that would have come down, just that particular TNAV component, given higher rates. Do you mean that size TNAV is still also what we should be pencilling in? Thank you.

William Chalmers
Thanks Chris. On the cost question first of all I will give you a few pointers rather than necessarily getting into the precise specifics of your question. But nonetheless hopefully they will be useful. As you say, we have got BAU cost base of £8.3 billion. We talked about the incremental costs to £8.8 billion being composed of added investment, plus the new businesses, and over time the strategic initiatives that we gathered. That is what makes the £8.8 billion. But the £8.3 billion is the base cost base. When we look at that, I talked about the elements, some elements of that if you like, for the moment at least, being fixed because of long term contracts, because those are typically with third party providers, consultancies, that sort of thing which we use a lot of in terms of our BAU business, albeit much of it is investment in its characterisation. Other aspects of the cost base are either entirely or at least partially locked in. Things like energy suppliers where we forward purchase energy. Those are helpful, but they do expire as time goes forward either in total or in part. So for example you probably have, let's say you have a dozen fixed contract arrangements with contractors. Those will start to expire on a kind of staggered basis in years looking forward. Same is true with energy forward purchasing. It starts to expire rather than just suddenly falls off a cliff in any given year. And so you gradually get more exposed to these types of costs over time.

In terms of the split within the cost base, we have cost base which is, within that £8.8 billion, which is roughly £5.6 billion, £5.7 billion operating costs, £3 billion investment costs. So that gives you a sense if you like of that much which is investment versus that much which is OPEX to your question.

And then finally in terms of compensation I think about, and Douglas will confirm this in any follow-up if it is off a shade, but it is around 40 per cent of our cost base is people based. That then gives you a sense to which you can start to apply some metrics and the types of sensitivities that you were mentioning just there. Hopefully some useful inputs.

In terms of IFRS 17 I think we talked about mid-single digits in terms of the TNAV hit which we would expect to see at Q3 2021. I don't think that has terribly much change because when I think about the moving pieces in terms of that IFRS 17 hit they are, as you say, somewhat impacted by interest rates for sure. But there are things like revaluation of insurance liabilities from prudent assumptions to best estimate basis for example number one. Now clearly there is a discounting factor there for sure but nonetheless the bulk of that stays more or less the same. Likewise the risk adjustment is a further element which is an offset i.e. a reduction. Again that is discounted, but more or less the methodology is the same. And then you see the CSM liability being included which is the liabilities that unwind over time. Again the concept remaining more of the same.

So I think your point is entirely fair, there is an interest rate effect there going on because a lot of these things that forward flows that in turn discount at higher rates. But if you think about methodology it is plus a very big item which is the move from prudent assumptions to best estimate number one. It is minus risk adjustment a much smaller item. And then it is minus again the CSM liability a much smaller item. So what you gain in respect of one forward discount, you lose in respect of another forward discount. It means that overall therefore the mid-single digits guidance that we gave for the TNAV adjustments, is probably still not far off. We will come back to that with greater precision, but I think it is the rule of thumb for now.

Chris Cant
That is helpful, thank you. You did say mid-single digit. I think it is me miss remembering it as 5p, which is obviously the quintessential mid-single digit. So thank you for answering the question, thanks.

William Chalmers
Thanks Chris.

Question 7 – Andrew Coombs, Citi
Good afternoon, three questions for me. I have tried to keep them all brief. Firstly IFRS 9 scenarios. I just want to get a feel for how and when you think about updating your scenarios to take, for example, the Bank of England on Thursday would come out with a 7 per cent unemployment rate in the base case rather than 6.25 per cent, would that imply that you would then be forced to update your IFRS 9 scenarios with Q4, or do you take a more holistic approach looking at a much broader range of forecasts? So anything you can say around that would be useful.

The second thing is that NatWest provides some useful granularity on the mortgage roll going into Q1 and then to the remainder of the year, next year. So anything you can say in more detail on that.

And the final one just going back to deposit beta, you talked about your experience being in line with the industry at 20-30 per cent. As I recall, some of your corporate deposits are SONIA linked so I assume that beta has been slightly higher on the corporate book. But again perhaps you could elaborate that. Thank you.

William Chalmers
Thank you Andrew. A couple of points there. First of all the IFRS 9 scenario. We will update the scenarios at every quarter as we see them. And in terms of the relevance of the Bank of England in that respect, it is a data point and it is obviously an important one because they have in some sense a unique insight into the market. And so we will certainly take a close look at what their forecasts are and indeed why they are what they are. It is also important because the Bank of England is a policy maker. And so to the extent their forecasts inform policy then again that is a further reason to pay attention to the forecast they are presenting. Now having said that it is only one base. And so when we look at the Bank of England we will pay attention to it. It is, as I say, rather a heavily weighted data point. But it does not determine what our forecasts are. And so as a result we will look at how we see the market, we will look at how others see the market. We will look at how the Bank of England sees the market. But all of those things together will determine our outlook rather than necessarily any single one item.

I will come to the third of the three questions and then come back to the second if I could. On the deposit beta, we have seen the deposit beta on aggregate of 20-30 per cent and that cuts across retail and commercial accounts. Now I mentioned earlier on that actually the pass on for any given base rate change has been, to an extent at least, fairly independent decisions between retail on the one hand and commercial on the other. And I wouldn't say there has necessarily been a systematic sense in which commercial has had more pass on than retail. I am not sure we would see it like that. I do think that within given base rate change we will make apart from decisions for the retail component, for the commercial component which is depending upon on how we see the customer proposition at that time, customer value in total. And then we will make an independent decision on each of those areas. So I suppose a long way of saying there has not been a particular distinction between retail and commercial in terms of the overall bias.

In terms of your second question, the fixed rate book that it is set to mature, the base point that I always have in my head which therefore perhaps is useful to give to you, the fixed rate book that is set to mature in the next 12 months is £60 billion. That is between the end of Q3 2022 to end of Q3 2023. £60 billion is the number that I use.

Andrew Coombs
And is that pretty evenly spread over the 12 months, just to give us a feel?

William Chalmers
It is pretty evenly spread over the next 12 months, yes. Pretty evenly spread actually looking at the numbers here.

Andrew Coombs
Okay that is great, thank you.

William Chalmers
Thanks Andrew.

Question 8 – Jonathan Pierce. Numis
Hello there, thanks again for doing this. Just two fairly quick ones please. The TNAV, not that it is a particular focus for many people we talk to, but for some it is a relevant valuation metric. I just wanted to check when you will actually give us harder numbers on the impact of the insurance changes. Presumably won't be a full year it will be sort of pro-forma 1 January 2023 announced Q1 2023. If I can just confirm that? And supplementary on TNAV, you are now carrying pretty huge negative cash flow hedge reserving, probably about £6.8 billion given the movement in Q3. If nothing else changed and base rate has followed the forward curve and 5 year swap rates followed the 5 year swap curves, how long will it take that £6.8 billion negative to roll off, is it essentially the same as the duration of the structural hedge or is it something else going on there?

Second question is on fixed rate bonds. Probably a bit more relaxed than many on the risk of a big shift of cheaper in deposits into more expensive time deposits. But was fairly interested to see that you fairly recently upped the rates on your 1 year bonds to 3.4 per cent, which is pretty good for a bank, and I have heard that you are offering higher net worth individuals some special rates of up to 5 per cent on these instruments. Why, it doesn't seem why you are doing that, why you feel the need to do that and whether it is actually attracting a lot of money into your time deposit base in the last few weeks. Thanks a lot.

William Chalmers
Thanks Jonathan. Three questions Jonathan which I will take one by one. In terms of the TNAV and the impact of the insurance changes on TNAV. We will be giving some disclosures as of Q4, that is our expectation. There is obviously a lot of work going on right now in respect of IFRS 17. But our ambition is to give disclosures as of Q4 about the overall effect of IFRS17 on the look forward earnings base, and as appropriately high level but nonetheless one that I hope will be useful to you and the market more generally. We will also be looking at the 2022, effectively the restatement, which is the IFRS 8 point I mentioned earlier on in response to a question. And we will be looking at two dates in 2023 to discuss that. One is the Q4 earnings release for the year-end earnings where we will do our best to provide you with IFRS 17 impact then. And then we will look at a transitional discussion which will probably be towards the end of Q1, beginning of Q2, something like that to talk further in greater depth. A bit like we do with IFRS 9 actually. And we will spend some time talking through with you the effect of IFRS 17 in that session. I suspect that a lot of the questions you will have, including on the TNAV points, will be significantly answered by the time we get to the year-end but I want to slightly stop short of promising too much because as said there is a lot of work going on right now and a lot of dependency over the next few months as we seek to bottom out some IFRS 9 uncertainty in it. It is the first time application not just for us but for the market as a whole. I think we are well ahead of where others will be in terms of our timetable disclosures. But I don't want to kind of pin us down too much until we make further progress. But nonetheless whichever way it is first half certainly is going to answer your questions and I hope by the end of the year. By the year-end results I should say.

Then second point on cash flow hedge reserves. As you say cash flow hedge reserve right now is £6.4 billion on the balance sheet, at H1 I think it was £3.2 billion so it has doubled in terms of its overall size from the rate increases that we have seen. Obviously speaking there, the sensitivity is £50 million post tax for 1 basis point increase in rates. And the duration point to your question, the average duration, average duration I should say of the cash flow hedge, is 3-4 years. Now you can tell by that the average duration being that length of time, that it is not significantly different to the structural hedge which as you know has about a 3.5 year weighted average life. And that as you know probably well, is not surprising given what it is there for. Its unwind if you like is therefore similar to the unwind of the structural hedge as a, roughly speaking, a correlation with that. I am sort of duty bound to mention the fact that the cash flow hedge volatility is there, it does drive TNAV but of course it doesn't drive capital and it doesn't drive distributions.

Then finally your fixed rate bonds question. Fixed rate bonds we have put forward 1 year bonds of 3.4 per cent as you say number one. We are also targeting products towards higher net worth individuals. And those are, they are seen driven really by two things. One is the desire to make sure that we have product offerings that are relevant to our customers. I made the point I think on Thursday that the reason our customers are coming to us with PCA deposits for example, the reason why we are not seeing much movement in deposits, is not because higher rate products are not available. They are available, 3.4 per cent is a good example of that. It is because customers are preferring to sit in instant access for now. As said, that might well change as rates change, but they do have product choices that are available to them if they want them. So being front footed with customer product choices is reason number one prior to putting these things out there. Reason number two on the higher net worth individuals in particular is because, as you know, we are trying to launch a mass affluent proposition as part of the strategy. And that is going to be rolled out, largely next year I should say, but we are starting to make some steps in that direction this year. Those high net worth individual offerings are a part of that build. Albeit it is very early days and we are going to see much more of it during the course of 2023.

Jonathan Pierce
Okay that is very helpful, thank you.

William Chalmers
Thanks Jonathan.

Question 9 – Martin Leitgeb, Goldman Sachs
Yes good afternoon, I'll keep it brief just being mindful of time. I just wanted to pick you up on an earlier comment on mortgages that a more holistic approach in terms of pricing also factoring in deposit pricing. Extended flow if you think about mortgage pricing could it get as close as pre global financial prices when we had interest levels similar to where we are heading to, or am I reading too much into that? I was just wondering from the lows we have seen essentially earlier in the year, critical you know much closer is there a kind of floor. What do you think about in terms of pricing?

And secondly I was just wondering mortgage rates being as high as 6 per cent recently. How do you think we let impact volume growth both in terms mortgage growth and also possibility of the deposit attrition. Thank you.

William Chalmers
Thanks Martin, I will take those in turn. In terms of the short mortgage margins. It is a good question and the last year has tested that issue. A couple of points that I would make. I think number one large providers, ourselves included, are always interested in maintaining market presence. And so there is a tolerance for low mortgage margins for a period of time.

I think point number two is that we make money on a marginal RoE basis off the back of some quite low mortgage margins. I won't put a precise number on it. But you know if you think about some of the application margins and mortgage margins that we have seen 60 basis points completion margin in Q3 for example. We are making a lot of money on that, on a marginal RoE basis. And so that is the second point worth bearing in mind.

Third point is that having said that, every time we have been in this territory of 50, 60 per cent completion margin pricing, we have at the same time seen a reversion if you like back to levels that are more akin to the planning ranges that we have had before, 75-100 per cent. And that reversion has not taken terribly long. You have seen tentative moves at first those have gained confidence and as a result margins have moved back into that zone. So I think that the floor question is one that it is worthy of discussion, but if there is a low margin for a period of time it is, in our experience, always followed by a reversion to more acceptable levels. So don't just give an acceptable or attractive marginal RoE, but actually give an attractive all in RoE. The market gravitates back to those types of levels, we have seen it time and again. And it is our expectation that we will see it again and indeed I think we are seeing it at the moment. There was a question earlier on about whether or not we might see some slowness if you like to reduce pricing because of risk returning to market. And I said I think actually more than that, I think it is a reversion to rational pricing. And we have seen it before and I think we will see it again. And as I say, we are seeing it.

The second point, mortgage growth, deposit attrition. I think inevitably as you get into higher interest rate environments that through the affordability pressures, through the first time buyer pressures, will start to have an effect on overall mortgage volumes and I think you have seen some of that in the very last pile of Q3 and you are seeing some of that play out in the course of, late in the course of, October and perhaps during the course of November. So I do think that higher rates take their toll upon mortgage growth and I think we are seeing some of that as we speak. However the deposit attrition point I think is a more complex point. And I say that because what we have seen, as you know our deposits in Q3 up by £6.1 billion including a significant chunk in retail despite a rising rate environment. Same has been true in commercial albeit as said on Thursday, some of those are short term by their nature. Secondarily I think people value security in terms of uncertainty. And thirdly and perhaps is the most important of the points, when we get into a more challenging macro environment, savings ratios tend to rise. If you ask our chief economist he will say the same. If you ask most economists they will say the same. Savings ratios tend to rise in times of greater uncertainty and tougher macroeconomic times. And of course that then leads to deposit inflows. Some of them will term, but we'll make a margin on term, some of them will be instant access. But that is the reason why I think saying that well mortgage growth is going to go down at the same time as deposit attritions are going to go up. I really don't think it is that simple.

Martin Leitgeb
Very clear, thank you very much.

William Chalmers
We have got time for a couple more if everybody is okay to carry on for you know five, ten minutes or so.

Question 10 – Joe Dickerson, Jefferies

Hi William. Just a quick one, not to belabour costs but given your comments of the income benefits significantly exceed any cost pressure you face going forward, I presume that you stand by the cost income guide of below 50 per cent by, I think it is FY26. I mean you have done 50 per cent year to date and 48 per cent in Q3. And I know there are things like bank levies to consider and all that. But you know you are already kind of there so I presume that you will be able to commit to that kind of postcode on the cost income. Is that fair?

William Chalmers

Thanks for the question Joe. It is an entirely fair question but I am just going to repeat the point that we will give guidance if you like on our outlook at the end of this year as we normally do. Safe to say it is your point, when you look at our cost income ratios for Q3 it is just a shade over 47 per cent. When you look at our cost income ratio year to date, excluding remuneration it is 49 per cent, including remuneration it is 50 per cent. So it is in the right type of territory, albeit we always want to remain ambitious with cost income. I think as we look forward, I mentioned earlier on that we are very committed to a cost savings that we committed to in the plan, through BAU and through strategic initiatives. That much has not changed. For the inflationary pressures are above and beyond what we anticipated in February and we'll be taking account of those. But I think the overall shape of the cost income point that you are making, which is to say that we see income growth. Part of it is rate inspired, part of it is organically driven, part of it is through the strategic initiatives. And we hope that that income growth exceeds the cost growth that we see. That shape if you like is very much within our plan, but I don't want to go further than that because we want to come at the end of the year and update on exactly how we see that taking place over the course of the coming years.

Joe Dickerson

Thank you very much.

William Chalmers

Thank you Joe.

Question 11 – Alvaro Serrano, Morgan Stanley

Hi William. It is more, maybe it is a good question to wrap up actually. More a sort of a general NIM question for the last two or three quarters we have been debating if the big rollover of Covid sort of mortgages was going to eat up the rate sensitivity. I guess now, for good or for bad, we don't have the same level of problem given where pricing is. And obviously deposit betas are surprising on the positive side and structural hedges even steeper, the curve is even steeper. So when I look at consensus and most of us have margins pretty much flat from Q4 onwards, just when you think about that confidence, you have touched on it on previous quarters, without sort of expecting a number from you obviously for 2023. But maybe some sort of touch on the confidence you have of that progression ongoing before, beyond Q4? Thanks.

William Chalmers

Thanks Alvaro. Important topic obviously. I guess the place to start is the Q3 margin which as you know was 298 basis points, that building off of 287 basis points in Q2 and that was a function of tailwinds of the BBR, base rate changes, and from the hedge, more than offsetting mortgage headwinds. When I look forward into the immediate future, which obviously means Q4, we see those patterns as repeating. That is to say we see the tailwinds from bank base rate changes and the hedge rollover again more than offsetting the mortgages. And so without being too precise about it, it is my expectation that we see some margin build from Q3 going into Q4.

Now looking forward on 2023, we are not going to give guidance as repeated a couple of times on this call. We will do that at the year-end, but when we look at the tailwinds and the headwinds we see tailwinds of again whatever remaining bank base rate changes there might be. But recognising that most of those are likely to be behind us by the time we get to the first part of 2023, i.e. they will have happened in 2022, number one. And then the second tailwind around the hedge redeployment which continues to be a very strong tailwind going forward. Albeit it is influenced at any point by the timing of hedge redeployment over the year.

So the headwinds as we look into 2023 are the mortgages headwinds start to intensify. I mentioned that £60 billion number just a second ago. And then of course as you know we are going to be looking to add a little bit of wholesale funding to replace things like TFSME in the business over the course of 2023 to get ahead of those maturities looking forward. And we are in an environment where wholesale funding costs are a little higher than were let's say pre Ukraine, although actually they are going back to where they were probably in 2021. But nonetheless wholesale funding costs being a little steeper than they were before that.

When we look therefore at 2023, again reflecting the fact that we will be giving guidance at Q4, there are a couple of unknowns around the bank base rate that will still be outstanding, although it is my expectation that most of those will be behind us. There is an unknown about the shape of the curve we will see and therefore the curve to which the, or rather within which, the hedge will redeploy itself. And there are some unknowns about mortgage pricing, we discussed those a couple of times on this call. What is important in all of that is to bear in mind as said the timing of the hedge maturities. It is significantly back in this into 2023 as opposed to necessarily evenly spread through the year, number one. And what pass through decisions we will be making as a business, number two.

So all of that means that we get a decent tailwind in the immediate sense in the margin going into Q4. What we see within 2023 really depends upon how those factors that I have been through play out. I would expect the margins to be solid going in there. But the exact direction will depend upon how those factors play out. Again we will give some more guidance on that at the year-end but hopefully that gives you some thoughts to how you might look at that going into 2023.

Alvaro Serrano
Yeah it does. Very helpful, thanks William.

William Chalmers
Thanks Alvaro.

Operator
Thank you and as there are no further questions at this time, this now concludes the call. Thank you all very much for participating.

William Chalmers
Thanks very much indeed.

END

FORWARD LOOKING STATEMENTS

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