Lloyds Banking Group plc – Preliminary Results 2009

The Plaisterers Hall, London – Friday 26 February 2010

Sir Winfried Bischoff – Chairman

Good morning ladies and gentlemen. My name is Win Bischoff. I am pleased to be with you today at this my first annual results presentation as Chairman of Lloyds Banking Group. I would like to make some brief remarks before handing over to Eric Daniels, our Chief Executive and Tim Tookey, our Finance Director.

My comments will cover our business, some thoughts about the banking industry and finally remuneration.

First of all on our business. It has been a year of challenge, but also one of achievement for our company. Under the strong leadership of Eric Daniels the business has positioned itself to benefit over the next few years from a strong earnings momentum. The constantly changing economic climate both in the UK and overseas, over the past twelve months, has obviously presented the banking industry with some difficult challenges. However, as we move into 2010 we believe that we are well placed to benefit from the encouraging signs of economic recovery, albeit we believe the UK economy will grow at below trend levels over the next few years.

Eric and Tim will take you through the main elements of last year's performance and share with you our strategy and guidance for the year ahead. I would like to pause briefly however at this point and touch on a number of issues relevant to our company and the rest of the banking sector.

Last year was a particularly difficult year for the UK economy. GDP fell by 4.8% As a retail and commercial bank with over 30 million customers across the UK, we are all too well aware of the financial stresses that many households and companies are experiencing as a consequence of the economic downturn. It is of course a privilege to have the opportunity to serve our customers. Given our scale, with that privilege come obligations. That is why we are playing a very active part in the UK economy's recovery.

I am pleased to note that we extended £70 billion of new lending last year, helping many households and businesses in the process. As the country's largest private sector savings institution, we also played a commensurate part in encouraging people to rediscover the savings habit, an essential component of any economic recovery.

More broadly we were, and continue to be, involved in all the Government schemes to encourage lending and to assist people or businesses in financial difficulties. We participate in all six of the household related schemes as well as all of the Government programmes helping small businesses.

To the extent that banking institutions, including Lloyds, meet their obligations of service and intermediation and are responsible and proactive conduits of channelling savings into productive enterprises and households. To that extent, and we hope, the trust in our institutions may be re-established. It will not happen overnight, but happen it must and it is up to us to ensure by our actions that it does.

It follows that it is right that there is thoughtful and considered debate on the shape and structure of our industry and not simply knee-jerk reaction by the industry.

Accordingly I believe that the combined efforts of a small number of the most prominent global institutions, perhaps with two or three of the respected industry bodies, should proactively help develop proposals which are acceptable to and can be supported by regulatory authorities and Governments. Such proposals could pave the way for an internationally agreed way forward, removing the uncertainty and scepticism hanging over the industry, both of which act as a brake on progress, to the detriment of the broader economies.

Let me finally say something about remuneration. We are conscious, who could not be, of the current public debate about remuneration in the banking sector. We understand that this is a sensitive issue for many people at a time when their personal finances are challenged and, in the light of the significant support given by taxpayers to our industry. We have thought carefully and responsibly about the design of our remuneration schemes. We are committed to maintaining the right balance between reward, risk management and performance. Specifically, we are active participants in the debate about the appropriate remuneration structures for the banking sector. We believe deferral and clawback are the way forward. These are already key features of remuneration design in the banking sector now and will be refined further, both here in the UK and abroad.

More importantly, and as already announced this past Monday, Eric Daniels decided to waive his bonus which the Board on the recommendation of the Remuneration Committee had awarded him in the conviction he fully merited it. Eric took this decision since he felt the public debate about bonuses in the banking industry was in danger of obscuring the very real advances which had been achieved by our Group in terms of capital creation, quality of revenues, earnings prospects and write-offs, and integration benefits. If I can make a personal observation at this point: we must find a way whereby remuneration models and performance criteria agreed and voted upon by shareholders will be allowed to be honoured without the recipient being put in a position, for the sake of the company for which he has in fact delivered the results, to feel he should waive the award arising from them.

We are, as you know, primarily a retail and commercial bank. This means that the total payout under our discretionary annual bonus schemes for 2009 will be but a very small percentage of overall revenues. All our rewards are subject, where appropriate, to deferral and clawback in line with the G20 principles and as agreed with UKFI and the FSA.

I would like to conclude by thanking all our investors for their support and the faith they have placed in our management team which I believe has been superbly led by Eric Daniels. I want with gratitude to highlight the role Government played in supporting Lloyds Banking Group and the banking sector in general during 2009 and Lloyds Banking Group more particularly during our fundraising at the end of 2009. With our strengthened capital foundations we are in a much improved position to develop our business and deliver significant financial performance and value for our shareholders, not least to the taxpayer whose support is greatly appreciated.

Let me now hand over to Eric Daniels.

Eric Daniels – Group Chief Executive

Thanks very much Win. Good morning, and thank you all for coming.

I will start this morning by briefly reviewing our performance for 2009 and take you through how we are positioning the Group to grow and outperform over the next several years. Tim will then provide the texture and detail behind our near term outlook and longer-term goals. We will then move into the usual question and answer session.

In my presentation this morning, I would like to focus on three messages. First, 2009 was a year of considerable achievement, in which we shaped the Group to enable us to deliver the growth potential of the enlarged franchise. Second, the core business will deliver a strong financial performance, given the trends we have already established on margins, costs and impairments and in a stabilising economy.

Finally, we have substantial additional growth opportunities from continuing to develop our business model and applying it across the broader franchise. As we realise the potential, it will enable us to further improve the growth trajectory in the coming years.

As a Group, we are just over a year old, but we have made great progress in addressing the immediate challenges. We have good momentum in all the core businesses and we believe the Group is now well positioned to deliver strong growth, both in the near and long term.

We have achieved excellent traction in integrating the two banks. We are now well ahead of our initial forecasts, and we have now increased our run-rate synergy target to £2 billion by the end of 2011. We have embedded the Lloyds risk disciplines across the Group. The results are already coming through and we have seen a significant reduction in the level of impairments in the second half.

During the year we improved our funding and liquidity, by reshaping the balance sheet and extending our maturity profile. We ended the year with a very substantial liquidity buffer of £88 billion. We undertook a major capital raising programme at the end of last year. That gives us the platform to continue to grow and supports our objective of returning to full private ownership. Overall, we made great progress last year and laid strong foundations for future growth.

Let me briefly review the Group's Results. On a management basis, we produced a loss of £6.3 billion for the year. Income was up 12% on prior year, helped by lower write-downs on treasury assets and the profits from debt swaps. These gains more than offset the year-on-year decline in margins, which suffered from increased funding costs and the impact of very low base rates. Costs were down 5% as we continued to manage expenses and began to deliver major integration benefits.

Higher income and lower costs drove a substantial 35% uplift in the trading surplus. We made excellent progress in improving our cost:income ratio. This fell by almost 900 basis points in 2009, although that contains a number of one-offs.

Impairments are the most significant number on the slide. At £24 billion, they are up 61% on 2008 and were the primary driver behind the management pre-tax loss. But as expected, they fell back in the second half of the year.

Looking behind the numbers, the business is performing very well. The development of our customer franchises has continued, despite the weak economy. This slide highlights some of the key numbers across the divisions. I won't go through them all but I particularly wanted to touch on our support for house buyers and businesses.

In Retail, we maintained our strong levels of mortgage lending, with £35 billion of gross new lending. This has helped thousands of our customers buy new homes.

In the Wholesale bank we committed some £10 billion of lending to SMEs and another £25 billion to Corporate customers. We are acutely aware of the importance of supporting households and businesses as we exit the recession, and we will remain just as focused on this in 2010 as we were in 2009.

We provided an increased level of guidance at our Interim Results in August and I am pleased to report that thus far we are trending in line or better on all of those measures. We set a target of delivering high single digit revenue growth in our continuing businesses within the next couple of years. We guided that our margins would fall in the second half of 2009 but would recover in 2010. We are actually seeing good progress on margins and actually saw margins increase in the back half of the year.

We are performing well on costs. We have achieved over half of our initial 3 year synergy target in the first year of the programme. Impairments are trending in line with our guidance, and we expect a substantial further reduction in 2010 and beyond.

Our balance sheet reduction programme is making excellent progress. We have already achieved a £60 billion reduction in non-relationship assets, and we completed the sale of five non-core businesses.

Looking ahead, we expect to deliver a significantly improved financial performance in 2010 and in subsequent years. We will benefit from improved margins, as we price for risk and as base rates gradually rise. We will continue to drive our costs effectively, and we have the additional benefit of the synergy programmes. We will see reduced levels of impairments, given the specific programmes that we have already put in place. With margins, costs and impairments all trending in the right direction, we expect to deliver strong growth for the next several years.

Let me expand on that outlook, starting with the economy. The economic performance last year was worse than most expected. Looking forward, we remain cautious but realistic. Our view is that the risk of a severe further downturn in 2010 is lower than a few months ago. And we are holding to our August forecast of 1.8% growth in GEP in 2010, with a similar trend in 2011.

Against that backdrop, we expect property prices will be broadly flat in 2010, which is below consensus. We anticipate that company failures will peak this year, but we do not expect them to reach the heights seen in the last recession. We also think unemployment will peak in 2010, but again at a lower level than the last recession.

Our financial outlook and guidance are based on a range of economic scenarios. Having stressed our portfolios, we are confident of our capital position and our expectation of improving financial performance, albeit the growth would be slower in coming through if there were a weaker recovery.

As we guided, our asset margin has improved, as we are pricing assets to better reflect risk and funding costs. The key drivers of our margin in 2010 will be asset pricing, a possible increase in the base rate and the cost of wholesale funding. We expect to be able to achieve a 2% margin this year, and to be on an upward trajectory after that. We see the largest positive influence as being the appropriate pricing of the book. An upward move in the base rate would also be positive, and we expect one increase later this year.

Beyond 2010, we envisage minimal impact from the cost of wholesale funding, as we run down our non-core assets and this will be more than offset by the moves to price new and existing business.

We have made great strides on delivering the integration, which is one of the largest financial services mergers ever undertaken. We exited the year with a run-rate of £766 million, a very strong start. Given we have now achieved half of our run-rate target, I am pleased to report that we are raising our guidance to £2 billion by the end of 2011. The rate of cost reduction however is not linear, given the build up to the major IT integration in 2011; but we are confident we will deliver as we are on track against all of our major milestones.

In August, we said that total Group impairments would peak in the first half, and the full-year numbers confirm that. The major driver of the improvement was in Wholesale, where the commercial property charges reduced substantially.

Retail impairments fell in the second half, driven by a large reduction in the secured book. This reflects the improvement in the house price index and better than expected arrears trends. Impairments in the unsecured book rose in the second half, as you would expect in the current part of the cycle.

The Lloyds' conservative approach to risk management is making a difference. All new lending is within the Group's risk appetite and the existing portfolios are being managed to Group standards. Our business support units have been expanded and extended Groupwide.

Looking forward, we expect to see a similar pace of half-yearly improvement throughout 2010, and further substantial reductions in 2011. We expect reductions in all three divisions, although we remain cautious on the Irish portfolios.

As I have just outlined, we expect improving margins, reducing costs and falling impairment charges. Based on these trajectories, we will deliver a strong improvement in our performance over the next several years. However, we believe there are also significant opportunities for additional growth. Over the last five years Lloyds TSB has delivered accelerating growth by focusing on acquiring, deepening and broadening customer relationships. We can see significant opportunity from sustaining this trend in the legacy Lloyds franchise, and extending the model across the Group.

Over the next few minutes, I would like to share some of the work we have underway and how we view the potential. These are clearly not forecasts but rather are examples that illustrate some of the opportunities.

Let me remind you of the results we are achieving in the Lloyds TSB retail franchise, and how that compares with the legacy HBOS. The left hand chart shows, that when attracting a new customer, the absolute level of cross-sales is higher in Lloyds than in HBOS, and that the Lloyds sales trend up nicely over time.

The right-hand chart illustrates how Lloyds deepens relationships with customers over time, taking a customer cohort opened in 2007 and tracking it over the last two years. HBOS has also grown relationship depth, but at a slower rate. Clearly, there is a big opportunity to further improve the old Lloyds performance and the results in HBOS.

We are addressing the HBOS opportunity by raising the sales effectiveness to Lloyds levels. As we have told you before, Lloyds is very good at using lead management systems to generate customer leads and convert them into sales. Finalta benchmarked Lloyds as being one of the most efficient sales networks in Europe.

As you can see from the chart, compared to HBOS, Lloyds is much more successful at both lead generation and subsequently converting the leads into sales. Based on the current Lloyds TSB results, our estimates suggest an income opportunity of some £500 million, from both new and existing customers, if we are able to successfully implement these practices into the HBOS network.

We also feel there is still a great deal of potential still to come from the Lloyds network. As the chart shows, the proportion of the Lloyds' customer base holding more than one product group is rising over time. I have shown you in previous presentations that multiple product holders are much more profitable. If we continue to deepen relationships and were able to achieve a 55% penetration of customers with multiple product holdings, it could give us another £250 million of annual income.

Here is an example from the Corporate Bank. As I told you at the half year, we are segmenting our customer base to identify those accounts where we have the strongest and deepest relationships, and which deliver significantly more income. We classify these customers as ‘trusted advisor and trusted specialist’ relationships. We have been working this model for a year and have been very successful in the trial segments. Analysis, based on that work, shows that we have the potential to treble the number of these more valuable relationships. We have estimated that if we were to realise the full potential, we would generate a £600 million income uplift per year.

Whilst I have been through the first three examples on this slide, we clearly have a range of other opportunities across the franchise. In Commercial, Lloyds TSB is the market leader for business start-ups based on our success in opening SME accounts for our personal customers. If we can replicate that performance in the HBOS franchise, we could generate an additional £50 million of income each year. By building deeper relationships across our entire SME customer base, we can see an additional £200 million revenue opportunity.

We have seen strong growth in the number of customers within the Private Bank in recent years, and established the Wealth division to build on that success. Across the Group we have identified some 300,000 clients who are suitable for our Wealth services. Were we to gain all this business, we believe we would generate an additional £250 million of income per annum.

Again, this is not an exhaustive list but just a few examples to illustrate the additional growth opportunity I mentioned earlier.

In finishing, I would like to leave you with my three key messages. First, 2009 was a year of substantial achievement, in which we shaped the Group to enable us to deliver the growth potential of the enlarged franchise. We have made great progress with integration, and we have greatly strengthened our balance sheet. We have achieved all of this whilst maintaining good momentum in the core business. The Group is now in a strong position.

Second, the trends in margins, costs and impairments are all positive. The management actions we have already taken in these areas, combined with the underlying business momentum, point towards strong financial performance in the coming year as the economy stabilises.

Finally, we believe that we have substantial additional growth opportunities from developing and extending our business model across the new Group. As we realise this potential, we will add to our growth trajectory.

Let me now hand over to Tim to take you through the Results in more detail.

Thank you.

Tim Tookey – Group Finance Director

Thank you very much Eric and good morning everyone. In the following slides, I would like to take you through some of the key elements of Eric's presentation in some more detail, further reinforce our confidence in the strength of our business and our strategy, and provide some insight into our expected performance over the next few years.

I will particularly focus on the improving earnings outlook, our progress on rightsizing the balance sheet, how we are improving our funding and liquidity position and maintaining a robust capital position. In 2009, the Group delivered a resilient trading performance against the backdrop of a difficult economic environment, and the continued challenges of financial markets. In addition, the integration of HBOS is progressing comfortably ahead of our initial expectations and as a result, as Eric said, we have increased the cost synergies target. All in all, we have demonstrated that our core business is in good shape.

Over the last six months, our lending portfolios have performed pretty much in line with our expectations and we believe that the overall Group impairment charge peaked in the first half of the year, as we guided with our interim results. We are making good progress in the rightsizing of our balance sheet, with a focus on the reduction of non-core assets. And our capital raising transactions have further strengthened our capital base and we have made significant improvements to our liquidity position.

Looking now at our business performance in more detail. For 2009 as I said, we can report a resilient revenue performance as significant year-on-year margin pressures were more than offset by the reduced impact of 2008's market dislocation. At the same time, we have continued to maintain excellent cost control with expenses down 5%. I will break out some of the component parts of our revenue and cost performance shortly.

As we all know, we took very substantial impairment provisions on the higher risk HBOS books in the first half, but in line with our previous guidance, we experienced a significant decrease in overall impairment levels in the second half of the year. With the positive effect of the fair value unwind, we have reported a loss before tax on a combined businesses basis of £6.3 billion for the year.

On this occasion however, I believe it is important to reflect for a moment on statutory profit. As you know, we paid less than half of book value when acquiring HBOS, given the problems in their asset books, and the large credit for negative goodwill means that we delivered a statutory profit in the year. A statutory profit is also important from a capital perspective as it flows almost fully into regulatory capital. Our statutory result in 2009 was a profit of just over £1 billion, reflecting the impact of the credit to the income statement from the negative goodwill arising on the HBOS acquisition. And this goodwill credit more than offsets two other large one-off items: integration costs and the £2.5 billion GAPS fee.

Looking briefly now at our divisional performance. I would like to focus on half-on-half trends because during the second half of the year, we saw some stabilisation in the economy which enabled many of our businesses to demonstrate improved business and earnings momentum in the second half.

Retail delivered a good underlying performance against the backdrop of slowing economic activity and significant margin pressure from lower interest rates. Margins in Retail decreased year on year, but improved in the second half particularly from increased product pricing in both the secured and unsecured portfolios. This combined with lower impairment provisions led to significant profit uplift in the second half.

Wholesale's loss for the year was due to higher levels of impairment. This was partly offset by the lower impact of market dislocation and continued strength in sales and trading activity. The second half result for Wholesale clearly shows the benefit from the significant reduction in impairments.

In Wealth and International, a solid underlying performance for the year was offset by increased impairment losses driven by the Irish downturn. As we cautioned at the interim stage, the difficult economic situation in Ireland led to much higher provisions in the International business in the second half and particularly in the fourth quarter.

Our Insurance business performed well in a difficult market but saw a reduction in income, and profit, as sales fell. This was partly mitigated however, by a very strong cost performance and an improvement in UK new business margins to 2.7 per cent in the second half.

Overall, the combination of improving margins, cost synergies, and lower impairments have led to a better performance in the second half, and these trends all bode well for the future performance of the Group.

Looking now at our key revenue trends. As I mentioned, 2009 revenue was supported by the absence of 2008's market dislocation. We have also executed a number of liability management transactions which generated strong gains over and above the fair value unwind that crystallises as a result of these transactions. Overall, we are pleased with the resilience of our revenues against the impact of lower deposit margins. And last year, this margin pressure reduced income by some £1.2 billion. In addition, the impact of moving to a monthly premium PPI product in January 2009, as you know, reduces the upfront income on these products.

Turning now to margins. The net interest margin from our banking businesses for the full year reduced by 24 basis points to 177 basis points, however again I want to focus here on the half-on-half trends, which are quite different, as we have delivered an improvement in margin in the second half. In the first half, the impacts of falling base rates and the lengthening of our wholesale funding profile were significant. During the second half, however, the impact of asset pricing and stabilising wholesale funding costs more than offset the impact of lower base rates. Notwithstanding the further maturity extensions that we achieved in the second half, the overall cost and mix of wholesale funding improved the Group margin by 4 basis points.

All new lending and all renewals are done at prices that reflect the appropriate cost of funds and, of course, proper pricing for risk. Within existing lending, the other major dynamic has been in our mortgage portfolios as customers continue to migrate to Standard Variable Rate offers as their existing fixed and tracker products mature. We expect this trend to continue, and we may see the proportion of our mortgage book on SVR, increase to around 50 per cent of the overall book by this year end.

Looking at our expectations for margins going forward. Now many of you will recognise this type of slide, which sets out our directional guidance in the key areas driving our margin, and I have updated this to reflect the changing trends we have seen in the last few months. The improved margin in the second half will, we believe, further improve over the next few years and we expect it to increase in 2010 to around 2%, with further improvements thereafter.

One area that I just want to touch on briefly is the potential impact on our margin of the re-financing of Government and Central Bank liquidity schemes over the next few years. The Group's balance sheet reduction plans will avoid the need for a proportion of this funding to be re-financed at all, and the residual re-financing, which we expect to come from increases in customer deposits and a wide variety of secured and unsecured wholesale markets, is not expected to cost significantly more than the existing schemes.

The current cost to the Group of participating in these schemes is around 50 basis points over Libor for the SLS and around 130 basis points over Libor for the CGS. Overall, and based on expected spreads and balance sheet mix, the increased cost of wholesale funding over the next few years is expected to impact the Group's net interest margin by no more than 10 basis points. This increased cost is expected to be more than offset by the impact of improved product pricing.

Now let's look at cost trends. The Group has continued its excellent track record in managing its cost base. During 2009, operating expenses decreased by 5% as integration related savings have started to be captured. This includes the impact of staff numbers coming down by over 11,500. Adjusting for lower operating lease depreciation, you can see that Business As Usual costs rose by some 3 per cent, reflecting continued investment in growing our core business, as well as increased pension costs and inflation.

Looking forward, we anticipate further cost savings from the integration over the next two years, more in just a second, and as a result of this we expect to exceed our continuing businesses cost: income ratio improvement target. After a couple of years of integration delivery, we will still be targeting further efficiency improvements as we seek to optimise our cost: income ratio in the medium term.

Now let me expand on our recent progress on integration. We have already made significant progress in capturing savings from areas such as rationalisation and procurement, and over £500 million of savings have already been realised. These represent annual run-rate savings of over £750 million. Clearly we are delighted with this progress, and as a result, we have increased our commitment to deliver a run rate of cost synergies and other operating efficiencies of £2 billion per annum by the end of 2011.

Let's move on now to impairments. The significant rise in impairment levels largely represented falls in the value of commercial real estate and the impact of the general economic deterioration during the year. This included the effects of rising unemployment, and reduced corporate cash flows, although we saw the effects of some of these issues start to reduce in the second half, with the impairment charge 21 per cent lower than in the first half.

In Retail, the increase in impairment losses year on year particularly reflected increases in unemployment on the unsecured impairment charge. In the second half however, this was partly offset by a lower mortgage impairment charge as house prices started to increase and the trend in mortgage arrears started to improve.

The Wholesale charge for impairment losses increased significantly, in particular due to the real estate exposures in the legacy HBOS portfolios which were much more sensitive to the downturn in the economy. As we predicted, we saw a significant reduction in the second half charge, as we began to see some stabilisation in these real estate markets.

In our Wealth and International business, the impairment charge rose quite substantially, particularly reflecting provisions against our Irish commercial real estate portfolio which we have been cautious about in our recent guidance.

Looking now at our previous impairment guidance and outlook. As Eric said, it is important to us when we provide market guidance on any part of our business, that we subsequently deliver on that guidance. I am pleased therefore that there were no negative surprises in our second half performance. We believe, given our current economic outlook, that the impairment charge in 2010 will be significantly lower than the 2009 charge. Our second half charge, as we know, was 21% lower than in the first half. Given our current economic outlook, we expect to see a similar pace of half-yearly improvements throughout 2010 with further substantial reductions in 2011 and beyond.

Looking at the divisions, compared to 2009, we expect to see a reduction in the Retail impairment charge this year with further improvements thereafter as the UK economy improves. In Wholesale, further significant reductions are expected in 2010 and beyond, based upon our current economic expectations.

In Wealth & International, we continue to have ongoing concerns with regard to the outlook for the Irish economy although we expect and believe that 2009 has been the peak for the International impairment charge.

Now turning to the secured mortgage portfolio. This is again the format of a slide that I hope you will all recognise, and I have put it up to demonstrate the improvements in our mortgage portfolio in the second half of the year. The values of our book that are both more than 100% loan to value and more than three months in arrears are very modest indeed. In fact, they total around 0.9% of the total mortgage portfolio, down about a quarter from the end of June. These slides are in your pack, but whichever way you look at it, whether it is arrears, customers new to arrears or repossessions data, all key trends in our mortgage portfolio are moving in the right direction.

Before moving on to talk about capital and liquidity, I just want to update you on our current expectations for the unwind of our acquisition related fair value adjustments. As a result of some accelerated fair value unwind in the second half of 2009, which of course related to our capital exchanges, the Group now expects some £2.5 billion, net, to unwind positively in 2010 and then during the next three years we expect smaller impacts. And I will of course keep providing an update on the timing of these unwind adjustments in future presentations.

So, just recapping for a moment on our earnings outlook if I may. The outlook for margins has improved, we have a significant cost opportunity ahead of us and our impairments are expected to reduce substantially over the next few years. All in all, this means that we expect our financial performance to improve significantly in 2010 and beyond.

But now I want to focus on our balance sheet. In the Group's Interim Results announcement in August, we set out our strategy to reduce non-core assets, including business which is outside our current risk appetite, by about £300 billion, of which some £200 billion was expected to be achieved by the end of 2014. It has always been our intention to manage these assets for value and, given the current economic climate, our primary focus continues to be on running these assets down over time.

I am pleased that £60 billion of the £200 billion ran-off last year, although I must confess, and you can see it from the chart, that part of this run-off reflected impairment write-offs. Otherwise we made good progress in reducing our treasury assets and non-core customer assets. Over the next few years we expect a further £140 billion to run-off from this portfolio.

The overall balance sheet reduction over time will provide the Group with increased optionality and flexibility from the resultant releases in both funding and capital. These benefits will be incorporated into the Group's overall business plans, which include actions to increase retail and corporate deposits over time. Together these actions will reduce the proportion of the Group's funding that is derived from wholesale markets and eliminate our use of Government and central bank sponsored funding facilities, whilst providing capacity for core business growth. And I would remind you that the impact of running down those portfolios is not expected to have a significant impact on the Group's financial performance.

Recapping briefly, we have made good progress in reducing our balance sheet assets, and creating greater flexibility for the business.

But now let's now look at how we have used this asset reduction to improve our funding position. If we strip out the insurance and derivative items from the Group's balance sheet, total banking assets are about £800 billion. This is largely funded by customer deposits and wholesale funding with the remainder coming from repos and capital. The balance sheet reduction we have achieved has enabled us to reduce our repo balances, and we have also reduced wholesale funding by some £17 billion. In addition, we have been able to avoid rolling over more expensive, "hot money" type deposits which we estimate to be some £20 billion whilst growing our core deposit balances.

As you know, a significant proportion of the Group's overall funding support from Government and Central Bank sources will mature over the next couple of years. However, the Group's balance sheet reduction plans will avoid the necessity to refinance a large proportion of this.

Turning to funding sources and how we have lengthened our wholesale funding maturity profile. Throughout the turbulence in global wholesale funding markets, the Group continued to benefit from a diverse range of funding sources, which have recently been enhanced by senior funding issuance in a number of new product areas, such as our first issuance in the US Medium Term Note market. The Group's wholesale funding base has proved to be very resilient, supporting the Group's balance sheet and with an increased level of longer term funding.

As we have said previously, over time, and as we see improvements in the capacity in wholesale funding markets, we expect to maintain the average maturity of the Group's wholesale borrowings with a maturity date of more than one year to be in excess of 40% which we consider to be an appropriate and sustainable long-term proportion.

Notwithstanding this, the Group has continued to extend the maturity profile of wholesale funding such that, at the end of the year, 50% of wholesale funding has a maturity date greater than one year, up from 44% a year ago. The maturity extension achieved has continued to de-risk our already prudent funding profile. Within this extension activity, you will see that the amount of more than one year funding has actually risen by £13 billion and the amount of less than one year maturity funding has reduced by £30 billion. A good illustration of our improved funding position.

Relative to the size of our balance sheet, we don't have excessive senior term funding requirements. Over the next 3 years, we expect our public capital and senior funding issuance to be in the range of £20-25 billion per annum. Approximately £7 billion of term funding for 2010 had already been completed by the end of January.

Turning to our liquid asset buffer. The Group's liquid asset portfolio has increased from £105 billion to over £150 billion and represents a liquidity buffer now 19% of total banking assets. And as Eric said, of this, £88 billion represents primary FSA eligible liquidity, which is a multiple of current regulatory requirements. So, we have made significant progress in improving our funding and liquidity position, which just leaves me time to talk about capital.

During the year, our risk-weighted assets have decreased by £5 billion as a result of a £40 billion reduction in assets being largely offset by pro-cyclicality. Within this Retail RWA's have increased as the deteriorating economic conditions have led to increased average risk weightings. Wholesale risk weighted assets have decreased as a result of a reduction in assets and currency movements being offset by the pro-cyclical impact of weaker economic conditions. Over the next few years we expect to see continued reductions in our risk-weighted assets as a result of both balance sheet asset reductions and a positive pro-cyclical impact as the economy continues to improve.

At the end of December, the Group's capital ratios were robust and were further enhanced by the issuance earlier this month of £1.5 billion of equity, which concluded the December capital raising, and which further increases the core tier 1 capital ratio by 30 basis points, to 8.4%. This, of course, excludes the potential benefit of the ECNs issued late last year. As a result, the Group is now in a solid position to deal with what are constantly changing regulatory capital requirements.

Let me now comment on the current consultations on capital requirements. We are clearly mindful of the discussions taking place among the policy makers across Europe, and globally, relating to the appropriate levels of capital, funding and leverage for the system and individual banks. The most notable of these comes from the Basel Committee and of course we are fully engaged in the consultation processes which will take place through this year, and possibly beyond. This is critical if the right balance is to be struck so that all potential impacts, including on economies, can be considered. Whilst it is too early at this stage to draw conclusions, I wanted to take this opportunity to share with you some of our early thinking around certain aspects of the current proposals.

Under the banner of raising the quality of capital, the Basel Committee is proposing a number of potential changes to the definition of core tier 1. If these were enacted, the Group would clearly be affected by the proposal to deduct 100 per cent of insurance business from core tier 1, and so we are looking at options for optimising our use of capital should this change be implemented. I would add here of course that we already had 50% of this potential deduction built into our medium term capital plans. So I colour this 'Amber', overall. The potential restriction of Deferred Tax Assets has received some comment, but I have coded this 'Amber/Green' because whilst we currently carry a Deferred Tax Asset, we expect it to reduce a lot before the implementation of any rule changes.

The other changes proposed to core tier 1, such as the treatment of AFS reserves and pensions, if implemented as proposed are not expected to affect our capital base significantly. The definition of future tier 1 capital securities may well be tightened, but we expect all of our existing securities to be grandfathered.

The proposals around increased risk weighted assets are mainly concentrated in 'investment banking' activities rather than 'retail and commercial bank' activities. Therefore, the impact from this aspect of the proposals is not expected to be significant at all. We note the proposed definition of a new leverage ratio but we will only be able to properly understand its potential impact after calibration.

In short, there is still a great deal of water to flow under the bridge with regard to the future regulatory capital requirements and we are actively engaged in the consultation process.

In summary we have strengthened our robust capital position. And so, in concluding, we can look back at a very challenging year, but one of significant achievements. At the start of the year, and at the half year, we provided extensive guidance and we believe that we have delivered against every aspect of it. Our core business is in good shape, with resilient revenues against an extremely challenging operating background. We have an improved outlook for margins going forward, we are targeting substantial cost synergies and we expect impairments to reduce significantly.

We are very happy with the progress made in the run-down of non-core balance sheet assets and we expect the Group's performance to improve significantly in 2010. We are now well placed to deliver significant growth from our relationship model across the enlarged franchise.

And with that, I will hand back to Eric.

Question and Answer Session

Question 1: John-Paul Crutchley - UBS

You have given us some very comprehensive guidance of what you expect for the year ahead in terms of the shape of the income statement and what you are doing on the balance sheet. What you are not saying, and I know Lloyds don't give public forecasts, but you have not said when you expect to be in the black in 2010, but can I just walk through what I think you said and just correct me on any issues I may have missed. In terms of where you are guiding to on the margin, it looks like net interest income will be up and broadly offset the sort of numbers you are talking about in terms of impairment. And in terms of non interest income, at the moment broadly equate to the cost base and the cost base obviously falling. And you have talked about the release of the fair value unwind too. So when you put all of that together it looks like, when you add it up, the Group has the potential to be in the black for 2010. I just wondered if you could just comment on those numbers and if there is anything else we should be factoring in?

Answer: Eric Daniels

If I understood it you are basically saying "we are trending the right way on margins, impairments and costs and so will that lead to a rosy 2010?" Is that the thrust of the question?

Further question

Yes I guess I was saying, if you add up in a sense what you are saying you know you reach the conclusion that you should be a profitable bank in 2010 and I am just wondering if you could comment whether there is anything else we should be factoring in?

Answer: Eric Daniels

I understand the thrust of the question and understand perfectly why you are asking it. I think we have given very detailed guidance, and I think we can't extend ourselves too much further than we already have. But I think that it is safe to say that we have a strong belief in the trends within the business. They are all moving in the right direction. We had a very strong year in 2009.

Answer: Tim Tookey

We are acutely aware that there is a range of different views in the room and half of you have us in your spreadsheets for profit next year and the other half have us in for a loss. What we wanted to do here was give as comprehensive guidance as we can, to share with you the positive trajectory we see and the fundamentals in the business, to enable you to all update your spreadsheets. What I can't do is complete them all for you. And as Eric said, we can't add anything specifically from the platform that isn't in the announcement this morning.

<u>Question 2: Robert Law - Nomura</u>

If you can't fill in the whole spreadsheet for us perhaps I could ask you to help us on one or two cells! I was particularly more seriously thinking about the net interest income line. You have kindly given us guidance on the margin and if I look at the sequential margin improvement in the second half of the year and roll that forward, that would be kind of consistent with the margin guidance you have given. My question relates to the movement in the net interest income. Because although you have seen improvement in the margin, the net interest income has come down in the second half of the year compared with the first. And I was wondering if you could give us some kind of rationale for that and give us some guidance as to whether you actually think the net interest income for 2010 will be up on '09?

Answer: Tim Tookey

There are a number of dynamics at play in that, not least of course what is going on on the balance sheet and the asset run down. What we are looking to achieve going forward is to achieve the asset run down with minimal impact in the overall financial performance of the Group and clearly there is a large proportion of the assets that are in there that are not generating enough of a return. And running those down over time will give us quite a lot of flexibility to manage our funding costs. And that will help us deliver the margin guidance going forward. There is nothing particularly in the trends in the second half that you are referring to. The one or two lumps in there around some of the treatment of the income that comes from operating leases, which is one of the reasons I pulled that separately out from costs is of course the two broadly offset between income and costs.

Further question

So would you expect net interest to be up in 2010?

Answer: Tim Tookey

Well I am not sure I can add to the guidance we have given, I am afraid that is probably one of the cells I can't fill in on your spreadsheet for you. I mean the fundamentals in the business are good. We are repricing a lot of business as it comes up. And of course we are growing the business. And that is one of the benefits of having the flexibility coming into the business to grow our core franchise business with customers for running off the non relationship assets we have in the business that really aren't performing for us.

<u>Question 3: Ian Smillie – RBS</u>

Two questions please. The first one is on the mainstream mortgage book in the UK. It looks like it declined at an accelerating rate through the second half of last year. So I was wondering if you could give us some colour as to what was happening there. What sort of margin was that business was rolling off the book at? And how we should think about progress in this stock of the mainstream mortgage book through 2010 please? The second question is bigger picture. Could you where possible walk us through the moving parts on the Group balance sheet, if the UK sovereign was to be single or multi notch downgraded so we could have an idea of what you think would happen to the business? I notice in the liquidity section there is a line saying that if that was to happen you may or may not be able to meet your funding requirements. So more colour on that area would be very useful please.

Answer: Eric Daniels

I will give a basic response and then ask Helen Weir (Group Executive Director, Retail) whether she would like to comment on the mortgage market. Basically what we have seen in the mortgage market is house prices did in fact perform better than I think anyone would have expected and we have seen some limited activity in new home buyers, but by and large the purchase of new mortgages has been very restrained. What we have done is focused our efforts really on first time buyers and on movers and that is what we believe is important in our relationship building. What we have not done is necessarily chased the non customers through the IFA channel. So that sort of shapes how we are looking at the mortgage business going forward. Helen if you can comment please?

Further answer: Helen Weir

I think the other thing that has affected the mortgage market in the second half is we have been very focused on our relationship strategy through selling mortgages through the branches. So actually the reduction you see in mainstream mortgages is primarily coming through the IFA's. And that is business that is coming up for renewal. A lot of it was put on in the back end of 2006 and in early 2007 and is relatively low margin and in some cases slightly negative margin business. So actually that rolling off our books has actually helped us. So that has been a core part of our strategy refocusing on our core relationship business through the branches. And to a certain extent allowing some of that less profitable business to roll off and refinance elsewhere.

Further answer: Tim Tookey

In respect to the last part of your question, I have a lot of respect and affection for our risk colleagues and they do insist that we write balance statements in the various bits and pieces that would encourage some people to jump off high buildings! I think what I would tell you though is that what we set out here are the various ingredients that make up our funding plan at the highest level for the next few years and should give you a high degree of confidence that the actions that we are taking in pricing the business that we do appropriately, both for the cost of funds as well as for risk. And running off the non relationship businesses. But doing it in a way that manages value rather than says, "I must have the liquidity at any cost", gives you a high degree of insight into the confidence that we have, that we can run the business successfully from a liquidity perspective over the next few years. So we don't regard that situation as likely at all.

Question 4: Peter Toeman, HSBC

I was sort of encouraged to see that your margin forecast for the second half of '09 proved to be about as inaccurate as my own forecast! But I think you are telling us that one of the reasons for that inaccuracy might be more because more customers are moving on to SVR (Standard Variable Rate). And I wonder as interest rates rise, then some of that sort of surplus mortgage return might be eroded by rates going up. So I wondered if that was a factor that could blow your positive expectations for 2010 off course?

Answer: Eric Daniels

We were pleasantly wrong! In fact margins turned around, instead of in 2010, a full half earlier and we are quite pleased. Tim took you through some of the drivers behind that, but basically if you are asking about our rate sensitivity, were there to be a base rate increase, what we believe is that in fact would be helpful. As you know, we have an enormous branch network and our savings and current accounts are worth a good deal less in a low interest rate environment. So yes the asset pricing, if there is a lag, will hurt margins somewhat, but that is more than compensated for by seeing the liabilities go up. So on balance, we think we feel pretty confident if the economy indeed performs to our forecast, that we will see margins go up during 2010 and beyond.

Answer: Tim Tookey

When we were out talking about our capital raise in the autumn, we at that stage were talking about stabilised margins and trends we saw in the mortgage book and the proportion we are moving on to SVR, a pattern we do think will continue. That is going to be part of the benefit in overall margins. I would also just point out of course that the funding markets were quite different in the second half of the year compared to the first. And indeed not withstanding the fact that we continued to push out our wholesale funding and de-risk our overall wholesale funding position further in the first half, we actually had a small margin benefit from wholesale funding in the second half compared to a cost in the first half. So mortgages is part of it, but I think I will continue to talk about the different drivers of margin going forward because there are so many component parts to it.

<u>Question 5: Tom Rayner, Barclays Capital</u>

Just to understand the trends in the second half of the year, because I think at the Interim Management Statement, you said that Q3 saw stable margins on the first half. So it looks as if Q4 margins have jumped to about 194 basis points. So just trying to understand that move and the guidance for 2010 would suggest a fairly flat profile on Q4 and I wonder what it would look like if we don't see any base rate increases coming through?

Answer: Tim Tookey

When we were out in Q3 you are absolutely right, we talked about stabilised margins. To me stabilised can mean plus or minus a few basis points from a particular number. And we didn't go out with our Q3 statement with full income statements so we weren't quoting specific numbers. So mathematically I am sure what you are doing is correct, but you are probably slightly overstating what was in Q4. We do believe from what we see going forwards and reflecting current spreads and the mix that I foresee coming through to fund the business over 2010, that we will bring the margin in at around 2% this year.

You asked about the impact of the base rate change. The impact will be relatively modest this year because I think it will come towards the back end.

Further question

On the wholesale funding, I would just like to press you a little bit more on your comment that you expect a minimal medium term impact from the cost of wholesale funding. Just looking at Tim's slide, (subtitle: Diverse funding sources with prudent maturity profile), the focus clearly is on 50% of your Wholesale funding being greater than a year. But you could look at it at 65% as a residual maturity of less than two years and that is quite a big number, £211 billion, and we know quite a big chunk has a Government guarantee. And you pointed out the costs of some of that like the SLS is fairly attractively priced funding. So I would just like to understand the dynamics a little bit more that as you go through the next couple of years, why there is not a bigger impact on your revenue expectations coming through?

Answer: Tim Tookey

There are a number of factors in play here. Firstly remember that there are a lot of relatively underperforming assets on the balance sheet, consuming expensive liquidity. We will be reducing those assets over time and therefore a certain proportion of it will not need to be refinanced at all. What we are also doing, is we said we wanted to build our core customer deposit base and that is both on the Retail side as well as the Wholesale space. So there is clearly a mix effect in here. What I wanted to do giving the guidance here, was give you insight into the different levers that we are pulling to manage the business going forward and de-risk it. And there is a lot of mythology around proportions of wholesale funding and maturities. There are different definitions out there. If I chose to use a definition used by another UK reported, I could have told you that our wholesale funding today was 60% funded more than one year. And you would have said 'Oh gosh isn't that wonderful'. So just be careful when looking at definitions and comparing one institution with another.

Further question

And if I can, just one final one, just on the old favourite revenue cost jaws. I think, taking out structured/market dislocation effects and liability management gains, it looks like underlying revenue was down 9% on the year. Costs actually down 1% again on an underlying basis. And that is despite synergies coming through a bit more quickly. It is not quite the aggressive cost management we are used to hearing from you guys. I wondered if you could comment on that?

Further answer: Eric Daniels

Very clearly we signalled, in looking at the income statement, that we benefited from the debt exchanges as well as the lack of Treasury write-downs. And they are fairly big numbers. But I would also tell you that our income statement has, forever, extraordinary items. So you have to take some kind of a reasoned view about what is the real level. As Tim told you on our expenses, what we have actually done is continued to invest in the business. I will give you some examples. We have started programmes for training all of our people. I think it is terribly important to build a common culture and so we won't skimp on that. We have also been investing in new systems as you would expect and beyond the integration investments, we are getting better information systems, better lead management systems and so on. So all in, our true rate of cost increase was somewhere around 3% including inflation. And so we think that is a very reasonable way to manage the business.

<u>Question 6: Mike Trippett – Oriel Securities</u>

I have a question on liquidity, if you could maybe help with what you think the impacts of increasing liquidity has been on the margin or what the drag on the margin is in 2010? And secondly longer term, do you envisage running with that same level of liquidity on a smaller balance sheet?

Answer: Eric Daniels

I think that what we have done is in taking over HBOS, we have stretched out the maturities. HBOS very clearly especially in the few months before we actually struck the deal, was pretty much taking liquidity at any cost at any duration. It was a liquidity issue. When we took over what we did is we took the entire balance sheet and basically developed a liquidity plan that would put us on the side of the angels. And that cost us a great deal during 2009. It was costly to stretch out the maturities. I think what we are signalling, and if you go back to Tim's chart about those influences that will drive margin going forward, we feel pretty comfortable that we have got ourselves to a pretty good place. We will continue to fine tune, we will continue to change the liquidity profile but we don't think it is going to have nearly the impact that we have had during 2009 when we were changing the entire balance sheet.

Answer: Tim Tookey

I think there is just one other point there that you raised Mike, which is what level do we think will be appropriate with a smaller balance sheet? I think what the industry is slowly beginning to understand in the way that regulators are proposing to take liquidity requirements, is that it is going to be a factor relative to short term wholesale funding. And so the shorter you fund wholesale, the more liquid assets you will need to have. And you can get to the ridiculous extreme of having no short term funding say in a three month window. You would need no liquid assets and the regulators will be happy. So I think going forward, there will be an increasing understanding amongst banks in the community, around the relativity of the proportion of liquid assets that you have to have and your short term funding. I think at the moment whilst these new requirements are still some way off settling down, and potentially some considerable way off settling down, we will maintain a level we think is appropriate to continue to hold a very prudent funding position in our balance sheet, And even just looking at 2009, we saw different markets in the first half to those that we saw in the second half. And during that time we have positively termed out wholesale funding. And we have maintained that high level of liquid assets. So yes it could change over time. But I think we will want to hold something that we will consider to be more than adequate until there is a lot more clarity from the regulators.

Further question

You have had a 50% increase in the liquid asset pool, what impact do you think that has had on the 2010 guidance?

Answer: Tim Tookey

Well clearly, carrying that kind of a liquid asset 'pile' has an impact on your margins, because we built most of it up in the period between March and September. And we showed that trajectory in the information that we gave at the time of the Right's Issue. The impact is built into the £1.2 billion margin drag that we quoted for the full year here. Wouldn't expect a big extra impact on that going forwards because of where markets are at the moment, relative to where they have been during 2009.

<u>Question 7: Arturo De Frias Marques, Evolution</u>

First of all on Insurance. You mentioned the full allocation of capital within Core Tier 1. Your current supervisory deductions are in the region of £11-11.5 billion, and I tend to use that number as a proxy for the capital that you would have to locate. If I do that and compare with the earnings from Insurance, that generates an ROE (Return on Equity) of around 3%, with full allocation of equity which obviously is less than ideal. You mentioned that you were thinking or you were considering options if this regulatory change takes place. So I would be very interested in hearing what options you would be considering?

Answer: Eric Daniels

Basically, if you recall back to the days of when we were looking at Scottish Widows and some of the same kinds of capital discussions were in the forefront. What we did was look to manage Widows in a substantially more capital efficient manner. And in fact over the 3 to 4 years we pulled about £4.5 billion capital out of the company. If we look forward, we have the very desirable position of having the largest insurance company in the UK, it is really a very desirable asset. We are getting very good synergies out of it. And we see some of those same kind of opportunities to in fact bring dividend capital back up to the Group and to therefore reduce the drag that you are talking about. So overall, we've guided about as much as we can, but we are fully aware of what the proposed changes are. We think we have a lot of water to go under that bridge before we finally determine what the capital will be. But in the meantime, we think that there is opportunity. In fact we have demonstrated with Widows, that we can in fact run the Insurance businesses in a much more capital efficient fashion.

Answer: Tim Tookey

The £11 billion you are quoting includes some other bits and pieces. If you look at page 29 of the news release, you will find the Insurance deduction quoted there at about £10 billion. So I think also, let's just remember there is a very strong dividend flow that comes out of the Insurance division every year and we took in, in terms of dividends about £500 million out during 2009. That number is buried somewhere in the news release if you can find it.

Further answer: Archie Kane (Group Executive Director, Insurance)

We have a programme looking at the opportunities to improve the capital position within the life companies. Now if I take you back to the early days of Widows, one of the things that we did round about 2003/2004 was to look at the capital we were consuming in the business, i.e., in the products and re-engineer those products so that we were consuming less capital. That is one of the things that allowed us to upstream more capital. We also then restructured the businesses. As Eric said, we paid back in excess of £4 billion over a period of 3 to 4 years. Now one of the things we have done in 2009 is compare and contrast the product set that HBOS had compared to the product set that Scottish Widows had. And when we have applied the internal rate of return (IRR) discipline that we used in Widows which HBOS was not really using, we have found quite a marked difference in the profitability of the products. So for example, we have withdrawn our Clerical Medical pensions product and replaced it with the Scottish Widows product. Now to give you an idea of the impact of that, that has virtually doubled the IRR of that product, because it is a completely different product. The Clerical Medical product was a high commission led product, i.e., capital consumptive. Whereas the Scottish Widows product that we now are rolling out more and more, is a factory gate priced product, which is not so capital consumptive.

Now the important thing to realise is that what we are going to do with the insurance businesses is a well beaten path. It is exactly what we did from ’03 to ’08 in Widows, so this is not something new. We are not going to try and reinvent the world. We are going to do exactly the same things through allocation of costs, product, internal profitability, application of IRR disciplines. And we see some great opportunities to improve the overall capital profile.

The last thing I would say is, we have also got a programme going, looking at the overall structure of all of the businesses that we have. And looking to see where we can improve and release capital from the various businesses that we have within the insurance division. And we have a list of opportunities whereby we will be able to do that. So you are absolutely right, it is a real issue, but we are really focused on that and in 2010 we will be doing some hard work on that.

Further answer: Tim Tookey

The performance of what Widows is doing in this year, you will find some interesting stuff buried in the news release, but there really has been some strong examples of exactly what Archie is talking about here. If you will just look at the EEV margins for example. I gave you a statistic from the podium on the UK life business, how the second half margin improved, but within that the performances of the two businesses are really quite different indeed. And if you just looked at how the Scottish Widows product set has performed, then the EEV margin there is actually up to 3.5% last year. So there really is some absolutely stellar work going on and some great opportunity for improving efficiency in the newly acquired life businesses.

Further question

The second question was on the procyclicality. I think you mentioned that you expected procyclicality to become a positive impact on RWA’s rather than a negative, which I found very encouraging. Do you have an idea of when that can start to be seen in the numbers?

Answer: Tim Tookey

Nothing that we have guided on specifically. All I could really say is look this will come as the economy improves and as we see improvements in some of the underlying drivers that in fact are risk weighting. So clearly we will need to see improvements in things like unemployment and things like that in the retail sector and improved confidence and strength of cashflows in the corporate sector for example. So the kind of things that actually we would intrinsically think would increase the likelihood of an event happening is those mitigate away so the risk weightings will come back.

Further question

And the final question is on the loan to deposit ratio in Retail. Yesterday one of your competitors was talking about 100% loan to deposit ratio in Retail as a target. But you still operate at 165%. I find it extremely remarkable that two banks operating in the same market have so different views in terms of what is the correct loan to deposits ratio in their Retail business. So can I have your comments on that? What is the ideal? What is the kind of aspiration for long term deposits for Lloyds?

Answer: Eric Daniels

I think that we use a series of very clumsy ratios to try and compare and contrast institutions. And I don't think they are necessarily terribly worthwhile. I think you have to look at a series of ratios and you have to look at the issue in aggregate. We for example, just did a rather significant RMBS, it was the first one that was done in some time. And that was a substantial sort of check in terms of our funding and liquidity plan, yet it doesn't impact the loan to deposit ratio at all. So I think a much better way to look at it is through a series of measures. We have given you some of them whether they are liquidity buffers, whether they are loan to deposit ratios, whether they are maturity schedules. And we will continue to give you more and more to try and help describe how we deal with the liquidity question. But I think the loan deposit ratio is of itself a worthwhile reference point, but certainly not the be all and end all. It doesn't really describe how the business is run.

Answer: Tim Tookey

Yes I totally agree, it is an interesting and relevant reference point. And our Retail ratio as you say is higher than I would like it to be. But one thing we are not prepared to do is to buy our way down to a lower ratio. You recall from the podium, I mentioned the fact that we have been successful in avoiding having to repurchase if you like "hot money" deposits by maintaining unprofitable, unsustainable rates. Now obviously not all of that was from the retail side, but some of it was. If I had chosen to continue to pay for those deposits, we could have improved the ratio and you would not have thanked me on the margin side of it. I actually would rather de-risk the overall funding as we are doing. So loans to deposit ratios are relevant, but I don't think a regulator would think it a terribly good idea to fund 100% of a Retail bank from customer deposits. What you are really saying there is we want 100% of your mortgage book funded by customer deposits that are basically withdrawn on demand. Is that really a sensible funding profile?

Further answer: Eric Daniels

One of the things we have to remember is that while there clearly were some issues and liquidity was very much the watchword during the past year, that one of the reasons why in fact we have seen more people in more homes, one of the reasons why we have been able to have business expansion is in fact because we have very efficient financial markets that allow some additional leverage over and above the very traditional, basically 19th century, banking if you will. So I think that we have to be very careful about the excesses, we have to be very careful about staying on the side of prudence, but to suggest that we basically have one for one funding, I am not sure that that would serve the economy terribly well or society terribly well.

<u>Question 8: Joe Dickerson, Execution</u>

If I look on your balance sheet, you have got about £26 billion of loan loss reserves in addition to the fair value adjustment on the HBOS portfolio. And I am wondering as the loss environment improves, you know it is roughly 3.5% of loans, as the loss environment improves, say going out to the end of 2011, what is your flexibility to release these reserves and what would the timing be? And then also what would be the priority for the uses of this release? And I ask in the context of the Government's stakeholding because if you could release say half of those reserves, you could pay off the Government's stakeholding. And then following on that, what is the plan to get HMT off the shareholder register?

Answer: Tim Tookey

Impeccably correct on your numbers, I have just found the table. So you are correctly extracting. I think I would encourage you not to go away, sadly, thinking that we have sandbagged the provisions and we are just waiting to be able to release them. The provisions that we set up as part of the Lloyds approach to risk management and impairment assessment are to look at the cashflows that we expect to get from an asset that has come under stress. And to look at those cashflows on a discounted basis and to provide accordingly. Now we would love to see some releases from those provisions. That will come if our assessment of the cashflows that will come from an impaired asset, actually improve in the future. And that could be because somebody who is in arrears gets back into a job and stops being in arrears. It could be because a building that is one short of a full set of tenants, gets a full set of tenants, suddenly the whole exposure for us changes. So it could be all sorts of reasons why we might have releases, but I wouldn't encourage you to go away thinking that we could simply take half of it back to income statements.

Answer: Eric Daniels

I think there has been a fair amount of speculation about the Government's stake which currently stands at 41%. I think we have been very, very clear that our ambition, our goal, is to return to being a wholly privately owned company, one that pays dividends and behaves as a normal bank. We have made no statements in terms of when we expect that to happen. I think that we would really be better served speaking or you might be better served speaking to the UKFI about that. We think that the best way to in fact achieve those kinds of goals of returning to full private ownership is to out perform, get the stock price up. That makes the sale of the Government stake very, very easy indeed. What we have told you today is that we have used the year well to build a solid platform for growth. That all of the trends, the key drivers are moving in the right direction and that we expect a strong trajectory of financial performance going forward. So we think that is our best route to achieving that goal I have talked about.

<u>Question 9: Ian Gordon – Exane BNP Paribas</u>

Just on margins. Sorry to recover old ground, but I am almost mildly incredulous at the suggestion that rising base rates for Lloyds could be a net negative for margins, it is certainly not what it says on your arrowed chart. So could I just ask a question around a slightly more negative scenario than your base case is, i.e., GDP growth less than 1.8%, slightly falling house prices, certainly no interest rate rise this year, maybe not next year. I think your arrow chart is still guiding us to a net interest margin of 2% plus in 2010 and 2011 under that scenario. I think you have been low balling us on cost synergies for 18 months or are you keeping a bit in reserve on margin 2%? And then the second question on costs, only a small point. Deferred bonuses clearly a smaller issue for you than your UK peers. Are you pushing any of the costs into future years like some of your peers are, or are you fully accruing the deferred compensation costs in your 2009 expense numbers?

Answer: Eric Daniels

I think the thrust of your question is are we in fact low balling and should you then mark your spreadsheets to the upside? I think what I would repeat is that when we give guidance, and we have given greatly enhanced guidance over the past couple of times when we have been on this platform, we take it very seriously indeed. And our clear policy and objective is to meet or exceed that guidance. I think if you looked at one of my charts and then one of Tim’s, we can tick a lot of those boxes. In fact all of the boxes on the guidance we have given. That said, what we don’t believe is that creating a false impression, i.e., that we are creating low barriers that we can jump over easily is necessarily terribly good guidance. We give what we think is reasonably meaningful. Now clearly if we have a different economic scenario we will have a different outcome. And we warned you both in Tim’s speech as well as mine, that we have a defined economic scenario and we are forecasting our performance based on the economic scenario. If we were to see a substantially worse environment, slower growth and worse house prices and so on, we undoubtedly would have an impact. What we have told you though is that within our stressed scenarios we are pretty comfortable with our capital position and we are pretty comfortable that we will in fact continue to achieve growth albeit a little slower coming through, if we were in fact to have a weaker recovery.

Answer: Tim Tookey

I agree with all of that and the answer to the last part of your question (on accruing compensation costs) is yes, we do expense in full.

Question 10: Aaron Ibbotson, Goldman Sachs

If I understand your guidance correctly, you have said that you expect high single digit revenue growth in your core operations. So I was just wanting to know what you view as your revenue contribution from non core in 2010? My second question is related to cost:income ratio. Earlier you said that you expect an improvement of 2% a year more in the earlier years and I wanted to know on a headline basis if this is true for 2010 as well?

Answer: Eric Daniels

In terms of our cost/income ratio, what we have said is that as we have the synergies coming through in the earlier years, that in fact we will do better than 200 basis points of improvement in the cost:income ratio and that would certainly apply for 2010 and 2011. So I think that if you look at the cost:income ratio improvement this year, admittedly with one timers, that we improved by 900 basis points during the year, I am not by any means guiding to a similar number for 2010, but we will have better than the 200 basis points of improvement.

Answer: Tim Tookey

The revenue guidance is around continuing businesses. So that is using a similar type of definition that we use when we are presenting results in the numbers that you see up here. So that is where for example you adjust out of comparatives sales of businesses. So for example, the numbers this year take out of the comparatives the impact of the sale of HBOS’s Australian business. So it is not about adjusting so much for non core asset run downs, this is adjusting for continuing businesses using the type of definition you find in the front of the news release.

Further question

Just to clarify Eric, then you are talking about a headline basis including your £1.5 billion in debt management income that you had in 2009?

Answer: Tim Tookey

Your start point should be to take the 2009 numbers and then adjust out the one time, on income, to give you the start point if you are trying to predict a cost/income ratio going forward.

Question 11: Asheefa Sarangi, RBS

Before we get carried away talking about releasing credit reserves, can we just ask about the coverage ratio and where you think that is going because at 44% it still looks relatively low?

Answer: Tim Tookey

It is interesting. I totally understand the question. We tend very much to look at the coverage ratio as the answer rather than something we are targeting. And it is very, very dependent on the mix. And if you have got the right approach to assessing your impairments going in, then you will come out with an appropriate coverage ratio, And I understand it is very, very difficult to compare different institutions. But obviously for a business like ourselves where half of the balance sheet is actually in mortgages, you could have an impaired asset, one that meets the definition of impaired asset, where the asset, it can be relatively large compared to the impairment provision that you would need to be effectively taking 100% of your potential exposure. So it is very difficult and I do feel for you all trying to compare different businesses on coverage ratios, but we are very comfortable with the coverage ratios that we have. We think they are appropriate and match our prudent approach to assessing impairment levels. .

Question 12: Jonathan Pierce – Credit Suisse

Coming back to net interest income and accepting that the banking margin went up in the second half, that obviously only captures albeit a majority, but only captures some of the total net interest income. And within the net income actually fell I think because the trading and treasury contribution fell from £800 million in the first half to nothing in the second half of the year. And I know that can move around a little bit, but I just want confirmation that there is no movement of certain types of funding cost out of what we may deem to be proper core banking businesses? And if you can give us some idea of where that trading and treasury net interest income goes this year, that would help?

Answer: Tim Tookey

Firstly I can put your mind at rest, there is no jiggery pokery between halves or moving funding costs. You know me better than that in terms of getting to the right answer. And in terms of that line going forward, I am afraid we cannot give guidance on any particular area or line of business performance in the future, that is something I can't give as I haven't got it in the news release.

Further question

Can you help explain why it drops so much then because it was an £800 million delta on the first half of the year?

Further answer

I don't think there is anything particularly in there. I mean there were different levels of performance from the different lines that are in there, but I am not aware of anything sinister or something I feel we should flag to you.

Further question

The second question is on the SLS (Special Liquidity Scheme), I was surprised to read this morning that the cost was libor plus 50 because effectively we were led to believe that it was like flat libor for all banks participating. Has there been some premium that you have had to pay simply because of the size of the SLS utilisation in HBOS?

Answer: Tim Tookey

We have never commented before on the costing of it. So I am not sure, where you say, "we have been led to believe". Certainly if you look at the SLS documentation, there is scope in there for the Bank of England to charge a higher premium where they deem that the take is more than they had expected. And that is what happened on the HBOS bit and that is why we have quoted that 50 basis points over today.

Further answer: Eric Daniels

What happened was that there are varying rates depending on the institution and depending on usage. And so what Tim is giving you is a blended cost for the two institutions and they are very different historically. And so what you are seeing is the overall blend of costs.

Further question

On the SLS affect on the balance sheet, whereabouts if anywhere, can we see the SLS monies that you have drawn within your funding breakdown or is it completely off balance sheet? Is it in Repos? Is it in the Wholesale lending breakdown that you provide?

Answer: Tim Tookey

That bit of it that has been repo'd, is in the repo bit which is in my columns on there and obviously some of it is still held in Treasury bills where if it hasn't been repo'd.

<u>Question 13: Andrew Lim - Matrix</u>

I have got a question on your balance sheet. Yes you are running off non core assets and indeed if you see half on half year, your assets are falling. And I see it down 3% but your risk weighted assets actually increased 2% half on half which I find quite surprising because there is a case that the non core assets that you are running off is higher risk than the book or business that you are retaining. Could you explain what is going on there and the future trends for risk weighted assets going forward?

Answer: Tim Tookey

Well we certainly expect to see future reductions in the risk weighted assets from the asset run downs we get as well as the effects of positive procyclicality. Certainly in the second half we did see some negative impacts of procyclicality. So despite what you sometimes see in the headlines, you need to understand the individual profiles of the different books. And clearly we work very closely with our colleagues in Risk and all of the modelling teams as we seek to predict what the appropriate risk weighting should be and the various factors that go into that. I think what you have got there is you can see the impact of some of that work coming through in the second half. But that should turn around as we see the economy improve, where we would expect both aspects of asset reduction as well as pro-cyclical effects to have a positive impact going forward, i.e., positive is lower, lower RWA's.

Question 14: Steve Hayne – Morgan Stanley

You kindly gave us a slide showing the impact on running down or right sizing the balance sheet. And you have an indication of the two forward going down. And on the slide it draws a straight line with an arrow. I think it is absolutely critical to the investment case to your stock about what happens to net interest income, that is the volume times margin. So I would really appreciate if you could give us a bit more of a view, I know you don't like to expand your guidance, but I think it is absolutely critical, what sort of run down schedule we should predict on that non core given one of your competitors only yesterday gave us an explicit year by year number that we as analysts can track. And for you I am wondering do I just effectively straight line it as you indicated on the slide?

Answer: Eric Daniels

I think the right way to think about it, and as you suggest, we can't give you any more guidance, that we have said that we have £200 billion that we will run off by the end of 2014. We have taken £60 billion of it in the first year. So that is about as much guidance as we can give you. We also said there is an additional £100 billion that we will take off after 2014. So again I think we have been pretty explicit. You will have to I think make up your own mind about the trajectory.

Answer: Tim Tookey

I would love to give you more information, but what I can probably best do is remind you of some of the things we said in the summer. We actually said in the summer that we thought there would be quite a slow start to the run off reflecting the economic conditions and that we would run the portfolio for value, which we felt would be running it down over time. What we saw were opportunities to actually accelerate some of the run down and do it in a way that had no impact on the income statement. So all we got was the positive impact from reducing our wholesale funding needs and the flexibility that gave us in funding. And you saw the benefit of that coming through in the margin impact in the second half. So going forwards, I know you want to do a volume times margin play to derive the income statement in your models, but we will run the portfolio down over time for value, and have minimal impact on the income statement. That is our focus.

Question 15: Michael Helsby, Bank of America Merrill Lynch

Firstly, I know you mentioned that Ireland clearly we all know Ireland is going through a difficult spot. But I think most people would have been surprised by the extent that bad debt jumped in the fourth quarter. So I was just wondering if you could give us some more colour. Clearly you have given us a broader bad debt guidance for the Group, but just what exactly are you thinking about in terms of Ireland? And second question, is Royal Bank yesterday gave us a stable funding ratio, I was wondering if you could give us your stable funding ratio for the end of ’09 and if the assets were run off as you think, what you might be able to get to by the time Basle comes through?

Answer: Eric Daniels

In terms of Ireland, yes very clearly we gave you in August a cautionary note in terms of our guidance. We were concerned about the Irish portfolios, we remain concerned about them. Basically they are very, very heavily concentrated in real estate, both commercial and residential. Basically there are therefore going to be a very high beta portfolio. The economy in Ireland is clearly not out of the woods yet. We have a rather bearish view of where the Irish economy is going, around a 2% drop in GDP and in our guidance we have said that we expect that in fact our impairments take that into effect. So we expect we will have peeked on the Irish impairments, but we are very cautious about them. There is less of a sense of confidence I think than we have in our other portfolios. Very fortunately they make up a pretty small part of our balance sheet. So I think that we feel very confident in the overall guidance that we have given.

Answer: Tim Tookey

Yeah on the second point Michael, no we haven’t quoted. I did see what Royal Bank of Scotland said yesterday and we had a quick look at this last night. We came out with a very similar number to Royal Bank of Scotland.

<u>Question 16: Simon Samuels, Barclays Capital</u>

Just on the balance sheet shrinkage, the £200 billion, in the summer Tim you put up a slide with a kind of a fan effect saying £200 billion down and going to grow by £100 billion and the net reduction was £100 billion. Is that still the case or are you now shrinking faster?

Answer: Tim Tookey

No absolutely. What we said in the summer was we wanted to create optionality and flexibility for us to reinvest in our core business and that is still the case today. In fact when you get a chance to read the CFO review in the news release, you will find us talking about building that flexibility into our business plan so that we absolutely have capacity to grow our core businesses.

Further question

So still to reinvest half of the shrinkage?

Answer: Tim Tookey

We said in the summer we would invest up to half and there is no change.

Further question

And the second question, picking up Eric’s last comment, on page 89 of the news release, you are obviously mega bearish in Ireland and really picking up the earlier comment about coverage ratios. Given that you have got £30 billion of advances in Ireland, £10 billion approximately are non performing, and your coverage ratio is only 37% against those NPL’s in Ireland, it just feels given all those comments on the uncertainty of the outlook, just feels a very, very light number?

Answer: Tim Tookey

Remember also you have got the fair value impairment provisions there which are also on page 89 are a further £5 billion which would increase the impairment provisions by more than 50%. So you are approaching a 60% coverage.

Eric Daniels

Thanks very much for coming one and all and we look forward to seeing you as we present the Interims, if not before. Thanks again.

End of Presentation