Lloyds Banking Group plc – 2011 Half-Year Results

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António Horta-Osório – Group Chief Executive

Good morning. It's good to see so many of you here again. Following our strategy event 5 weeks ago, I am pleased to present to you the half year results for the Group.

The theme of my presentation today is delivering resilient business performance, in line with expectations, despite challenging market conditions. Before I go into the detail of our performance I wanted to provide some commentary on the economic and regulatory environment in which we operate, which remains challenging.

These continuing challenging market conditions were, however, a key consideration when developing our strategic review and in this presentation I will also cover a number of the key aspects of our strategy and the resulting guidance. Though much of this will be familiar to you given that I only presented the strategic review 5 weeks ago, I think it would be useful to reiterate the key elements.

It is clear that the external macro economic and regulatory environment remains uncertain. Our marketplace and the expectations of our customers are changing. As I have said previously we need to regain our customers' trust and provide the products and services they need in an increasingly competitive market. This is core to achieving our aim of being the best bank for customers.

At the same time the financial pressure on consumers has remained high with rising inflation more than offsetting increases in income, such that real incomes fell at the fastest rate for 34 years in the first quarter of 2011. Consumers are continuing to grow the value of their spending in line with their incomes but that is translating into lower spending in real terms, a key reason why the economy has remained weak. Pressure on households' finances has also resulted in a renewed slowing in growth in deposit market balances. Demand for credit also remains subdued in both unsecured and mortgage markets. Consumers appear to be managing the squeeze on real incomes without increasing borrowing, but through reducing their savings levels.

The regulatory environment remains challenging but we are starting to see greater clarity in a number of areas. There are however a number of different issues that are likely to have a fundamental impact on the business going forward including future capital and liquidity requirements, the impact of any potential ring fencing and the impact of other ICB recommendations in September.

We continue to have a cautious outlook for the UK economy. Much has been written about the potential outcome of the austerity measures on the UK economy and their impact on key economic indicators in the short and medium term. What we can infer is that the most likely scenario continues to be one of a slow recovery and we will continue to remain cautious.

There has been a softening of economic data in the last five weeks but our economic expectations have not changed since I presented the strategic review and our outlook for GDP expectations remains broadly in line with consensus. We expect UK base rates will increase at the end of the second half of 2011, with unemployment slowly improving from the second half of this year, and property values stabilising.

Our main scenario continues therefore to point to a slow recovery, in line with consensus, with continued deleveraging and high inflation for some time to come. On the other hand, as we discussed five weeks ago, there are some additional scenarios of additional macro economic risks such as a double dip or contagion from a sovereign debt crisis where the probability of a recurrence has recently increased.

Against this backdrop, our decision to accelerate our non core disposals and strengthen our funding position in the first half of 2011 was key. Reducing the risk in the balance sheet and adapting our business model to be more resilient to any future volatility in the markets will continue to benefit the financial strength and competitive position of the Group

The business performance in the half year has been resilient given the economic and regulatory uncertainty and the significant challenges facing the business. These results are in line with our expectations. Tim will provide more detail on the financial performance of the Group with substantially greater disclosure on both core and non core businesses.

We are reporting an underlying profit before tax, which excludes liability management and ECN effects, of £1.3 billion in the first half, up 36% on the prior year. This is a resilient performance based on falling impairments and slightly lower costs substantially offsetting a fall in underlying revenues. In our core businesses the Group generated an underlying profit before tax of £2.9 billion in the first half and Tim will add more detail on this.

At the same time we have continued to reduce the Group's risk profile and we have made good progress in improving the Loan to Deposit ratio from 154% to 144%, reflecting the balance sheet reduction and strong deposit gathering programmes during the half-year, whilst maintaining our robust capital position.

We continue to make strong progress with integration, and this is now in its final stages. The benefits of this and our property, procurement and IT related programmes will continue to flow through and drive us towards our overall annual synergy targets of £2 billion by the end of this year.

From an IT perspective we have already rolled out the Lloyds counter system to Halifax and Bank of Scotland branches and migrated HBOS ATMs to the Lloyds platform. This puts us in a good position for the final migration of Halifax and Bank of Scotland customer accounts and data to the scaled Lloyds platform. This is an immense exercise involving the migration of approximately 30 million customer accounts but this platform will be the foundation for the Group's transformation plans. This exercise will complete later this year as we forecasted.

The focus will now start to move to simplification and as the integration initiatives complete, more resource will be freed up to deliver the simplification initiatives I outlined to you in June.

We have continued to make significant progress in reducing the Group's risk profile and strengthening the balance sheet.

We have reduced our non core assets by £31 billion in the last six months and they now stand at £162 billion. We've improved our funding position, with £25 billion of term funding raised in the first half and grew our core relationship deposits by 3% in the same period. These actions helped facilitate further substantial reductions in liquidity support from government and central bank facilities, with only £37 billion now outstanding at the end of the half year.

We also continue to progress the Verde disposal process. There is not much I can report here but we have now received a number of indicative offers which we are reviewing. We will now move on with the process and we continue to expect to have identified a purchaser by the end of this year. In line with the original timetable we do not expect the transaction to complete until 2013 given the complex separation and business migration issues that will need to be resolved.

I want to provide some additional information in the next few slides on the very real progress we are making on our commitment to placing the customer at the heart of everything we do. The Group continues to prioritise support for the UK's economic recovery at both corporate and retail levels through the range of services we provide to our business and mortgage customers.

Within the 'Merlin' agreement with the UK Government, the Group and four other major UK banks announced in February the intention to enhance support for the UK economic recovery by jointly delivering increased gross business lending in 2011 compared to 2010. Based on performance in the first half of this year, the Group is on track to deliver its full year contribution to the Merlin lending agreement.

As at the end of June 2011, we have provided £21.2 billion of committed gross lending to UK businesses, of which £6.7 billion has been to SMEs. The year-on-year growth to SME's was 2% as at the end of June 2011 which continues to compare favourably with the negative growth of 4% in SME lending across the industry reported in the latest available data from the Bank of England.

From a retail perspective the Group has achieved an approximate 20% market share of gross mortgage lending in 2011 and we have continued to support the First Time Buyer market in which the Group achieved an approximate 25% market share.

We continue to proactively support the UK housing market and our customers, through other schemes including the Equity support scheme, which enables people in negative equity to move houses, and the Lend a Hand local authority scheme, which enables local authorities to help people onto the housing ladder.

We also continue to participate in the unsecured market and helped nearly 300,000 customers buy cars, improve homes or tidy up their finances. We have continued to deliver strong deposit growth at sensible prices in a weakening market. We increased retail customer deposits by 2.8% whilst the market increased by just 0.7% in the half-year.

Our multibrand relationship led strategy and focus on delivering tailored products has been successful in both the Lloyds TSB and Halifax community banks with particular success with our Halifax ISA products. Over 300,000 Halifax ISA accounts have been opened so far this year, almost as much as in the whole of last year already.

Overall we have really invested in our customers, launching the ISA promise, which ensures we pay interest from day one of receipt of the application, to tackle a major cause of customer complaint, achieving a significant increase in 'best buy' mentions and winning awards in a number of 'Moneyfacts' categories.

To become the best bank for customers we need to deliver improved customer service. We will be opening all Halifax branches every Saturday by the end of August to provide added convenience for our customers and we have enhanced our Lloyds TSB internet banking offering to enable our retail customers to transact more online, and of course Halifax customers will benefit from this after the migration is complete later this year.

To strengthen our vision of being the best bank for SMEs, we launched our Best for Business campaign, and reaffirmed our continued support for the SME Charter to respond to 90% of lending appeals within 15 days which will exceed the industry standard of 30 days.

I am very pleased with the significant number of awards Lloyds Banking Group received in the first half of this year, including the 'Bank of the Year' at the Real FD/CBI Excellence Awards, which we have won for the seventh year running in recognition of our continued support of UK businesses and I am particularly proud of the broad range of external recognition achieved across the Group.

These all reflect the outstanding commitment of our people right across the Group, to deliver quality products and high quality service to our customers and communities. As part of our strategy to become "the best bank for customers" we publically committed to a number of stretching targets to reduce customer complaints and I am pleased to report that we have already made great progress.

Our main target was to reduce the level of FSA reportable complaints we receive by 20%, between the first half of 2010 and the first half of 2011, excluding PPI complaints. We have achieved a 24% reduction which has also reduced our complaints per 1,000 accounts to only 1.7. Considering the last data reported by the FSA in February this result would have ranked us at the top of our peers assuming no change since then. This has been accomplished through the training and support we have provided to our 40,000 front line colleagues. As a result we are also now resolving over 90% of complaints at first touch. We have also reduced the number of complaints overturned by the Financial Ombudsman Service to less than 2 in 5.

In the second half of the year we are rolling out an externally accredited complaint handling qualification to all of our complaint handlers. This programme makes us the first Financial Services organisation to have professionally qualified complaint handlers.

Despite the significant progress we recognise that we still have much work to do, which is why we have now also announced ambitious targets for the remainder of 2011. These include:
– Reducing complaints further by 20% year on year, and
– Reducing complaints overturned by the Financial Ombudsman Service to 1 in 5.

The considerable progress on these customer initiatives is entirely consistent with the key objectives outlined within the Strategic review, which I will summarise in the following slides:

Our strategy, as you know, has a three to five year outlook but as I have already outlined we have undertaken a series of rapid, focused actions, including starting a number of strategic initiatives. These include accelerating the divestiture ('Project Verde') required by the European Commission, de-layering the Group's organisational structure and further strengthening its balance sheet by paying down £60 billion of Government and Central Bank funding in H1 2011.

As part of our strategy, we will refocus our business portfolio to fit our assets, capabilities and risk appetite. We will focus on attractive UK customer segments, reduce our international presence, and continue our disciplined reduction of non-core assets, to ensure sustainable, predictable returns on equity above our cost of equity.

We will also simplify the Group to improve service and target delivery of £1.5 billion of annual savings in 2014. I will provide more detail on the specific initiatives we are looking to implement on my next slide.

Cost savings driven by the simplification programme are expected to enable an additional £2 billion of investment over the period 2011 to 2014 to grow our core customer franchise and deliver strong, stable high quality earnings streams over time. We will be very disciplined in assessing the investments we make, and they will be subject to rigorous tests. These will include their fit with our overall strategy, their financial returns, and their fit with our new risk appetites.

You heard me talk about simplification at the strategy review and the programme is critical to delivering benefits for our customers, our business and our colleagues. Simplification is about how we do business and what we do, day in day out. It isn't just another programme but a way of life, ingrained in our day to day activities.

We have more than 100 simplification initiatives planned, many of which have already started, and although I have already outlined a number of these, including the changes to the organisational structure, I thought it would be useful to provide some more detail on some of the specific activities being undertaken.

Firstly, simplifying end to end processes. We are looking to revolutionise the way we work with the introduction of end to end processing across the Group. Transformation of our processing is the single biggest initiative within the simplification programme which we expect to deliver over £500m in benefits alone. We'll focus on simplifying end to end processes through first touch execution, automation, image and workflow management.

Secondly, procurement. We are looking carefully at our suppliers and the way we buy products, services and materials. The benefits of getting this right are enormous. We currently have more than 18,000 suppliers, our target is to reduce this to 100 lead suppliers with 10,000 suppliers in total.

And thirdly IT infrastructure and systems. I have already highlighted the significant progress made in integrating IT systems to date. We will continue to invest in further IT projects to support simplification and growth initiatives over the next few years. As we deliver improved and simpler systems, we'll become increasingly agile and will be able to react quickly to enhance our service and product propositions. In short, we will have the right IT infrastructure to enable us to deliver significant benefits for our customers.

Five weeks ago I outlined five example growth initiatives at the strategy review including the development of Halifax as a challenger brand, becoming the UKs leading bancassurer, becoming the leading through the cycle partner to UK SMEs, developing our Wealth proposition and developing our wholesale markets businesses to capitalise on our corporate lending relationships. I should stress that these were only a few examples of the type of investment we wish to make from a quite comprehensive and granular set of initiatives to be implemented over time to drive revenue growth in the future.

Although it is only five weeks since the strategic review was announced I can already update you on the progress we are making on reinvigorating Halifax, as a challenger brand in the UK.

We want people to recognise the Halifax again for what we're good at – simple, great value products and friendly, upbeat service. We will therefore be revitalising the brand and launching a new advertising campaign in the autumn with the intention of cementing its challenger position in the competitive retail market

Turning now to guidance on our financial targets. Our guidance given in our Strategic Review announcement on 30 June remains unchanged. Further detail on our 2011 guidance and 2014 financial targets is given in the News Release and I have re-outlined the 2014 group targets on this slide.

In summary, we are making good progress in reducing the Group's risk profile. Our success in reducing non core assets and increasing customer deposits has meant we were able to accelerate the repayment of government and central bank facilities with only £37 billion now remaining. We also continue to make great progress against our funding objectives and our loan to deposit ratio continues to fall.

At the same time we have seen a resilient performance in the business, in line with expectations, with falling impairments and slightly lower costs substantially offsetting a fall in underlying revenues, despite the market conditions in the UK and abroad. Our focus will continue to be in supporting our customers and in doing so we continue to support the UK's economic recovery. I'm proud at the same time that we have substantially improved our customer service proposition and reduced complaints.

We continue to monitor economic conditions closely, notably in the UK and Eurozone, and remain mindful of the challenges of continuing regulatory uncertainty, particularly ahead of the final report of the Independent Commission on Banking in September.

As I said in June this will be a 3-5 year journey as it takes time to build a high performance organisation in retail and commercial banking. Given the high quality people we have, the series of rapid, focused actions we have been taking, and the progress made in the half year in strengthening our balance sheet, we are well positioned to realise over time the full potential of our organisation, brands and capabilities, and ultimately to achieve strong, stable and sustainable returns to shareholders.

I will now pass over to Tim to provide further detail on the financials for the first half of the year.

Tim Tookey – Group Finance Director

Thank you very much Antonio and good morning everyone. This morning I'm pleased to present the Group's results for the first half of 2011. In addition, I want to spend some time giving you an update on our continuing balance sheet de-risking through the run-off of non-core assets. And finally, we will talk about capital, funding and liquidity.

As you will have seen from the news release this morning, we have provided an enhanced core and non-core disclosure, with more detailed cost and divisional financial information and hope you will find that useful.

Firstly then, looking at business performance at the Group level. In the first half of this year, the Group delivered a resilient performance in line with expectations, with underlying profits up 36% at £1.3 billion.

Underlying income, which excludes ECN movements and last year's liability management gains, fell by 12% to £10.4 billion but this is also after including losses on non-core asset sales of £875 million – the sale of which facilitated substantial central bank facility pay down during the half.

With costs down 2% and impairments down 17%, this shows that the fundamentals of the business are indeed sound. Aside from these factors, the reduction in underlying income was partly due to a lower net interest margin, but in line with the reduction in our average interest earning assets, both for the Group and for the core business.

Looking at our results on a statutory basis. Well I have started this reconciliation by adjusting the underlying profits that we just looked at by of course including last year's liability management gains and the movements in each period in the ECN valuations to show the combined businesses result.

We saw a reduction in the statutory result to a loss before tax of £3.3 billion in this first half. In addition to the reduced profit on a combined business basis which I just explained, the statutory result primarily reflects the PPI provision, as well as further integration costs, and the absence of the pension curtailment gains we saw in the first half of last year.

Let's now look at the Group's income performance. As I said, Group income decreased by 18% but underlying income, decreased by 12%. This decrease includes a fall of £470 million in core businesses which I will explain in a moment, and £875 million of losses on disposal of treasury and other non-core assets, but please remember that these losses were largely offset by a related and accelerated fair value unwind of £649 million which is included lower down the income statement.

Excluding these losses on disposals of non-core assets, underlying income fell by 5%, which is almost exactly in line with the reduction in average interest earning assets of 6%.

Let's look at that core revenue performance now. So, if I break out the single '*core'* brick I had on the last slide, we can see here in detail the drivers of the 5%, or £470 million reduction in core income.

This reduction is dominated by an adverse movement in banking volatility in other operating income. The reduction in core customer balances had only a small effect and was offset by other factors, including modest core margin expansion.

Having noted the minor trend impact from core balances and the core margin, it is perhaps worth looking now at the overall core profitability and performance. As we saw, core underlying income decreased by 5%, which principally reflecting subdued new lending demand and continued deleveraging.

The core net interest margin increased slightly to 2.35%, mainly reflecting the improved funding mix in the core business, with a higher amount of deposits and a smaller amount of wholesale funding. The core impairment charge was flat on a year ago and down on H2 2010, principally reflecting a reduction in the Retail impairment charge driven by the unsecured portfolio, and partially offset by an increase in Wholesale, which is primarily as a result of lower recoveries on disposals of assets.

Core business profit before tax was down 28% compared to the first half of 2010. But excluding liability management and ECN effects core business profit before tax decreased by just 6%, again broadly in line with the smaller balance sheet.

So having touched on the core margin here, perhaps it's now time to look at the group net interest margin in more detail. The net interest margin was 207 basis points in the first half compared to 208 this time last year and 212 in the second half of 2010.

The H1 margin is a couple of basis points higher than I had expected as we enjoyed two favourable factors. Firstly:
– the benefits in the calculation of running off some lower yielding non-core assets.
And secondly
– the real benefit of a change in funding mix with an increasing proportion of funding coming from retail deposits rather than wholesale funding, and this mix benefit is happening faster than expected.

As I have said on a number of occasions, predicting margins is far from easy but, as I look forwards, I still expect the full year margin to be just over 2% which implies a second half margin of around 2% of course. This guidance is supported by the growing impact of the annualisation effect of repaying relatively cheap central bank funding and also the increasing weighted average cost of wholesale funding, including that the effect of the fairly expensive H1 issuance will only be fully felt in the second half.

In the medium term, the current margin trend will reverse driven, as I have guided before, mainly by increasing base rates and lower new wholesale funding costs and an improving funding mix. The lower wholesale funding costs will come from lower absolute issuance needs and lower issuance spreads that we expect as the funding markets settle over time and recovery sets in. These factors will, as I have said before, support the group margin expansion to our target range of 215 to 230 basis points by 2014.

Let me turning now to our cost performance. During the first half, operating expenses were slightly down, 2% in fact, benefiting from further integration savings and lower levels of operating lease depreciation, and absorbing increased employers' National Insurance contributions, higher VAT, inflation etc.

We have not been able to accrue for the cost of the Bank Levy during the first half of 2011. However, we continue to expect the cost of the Bank Levy for the full year to be approximately £260 million. If this cost had been spread evenly and therefore into the first half, costs would have been broadly flat, in line with our previous guidance.

I would now like to spend some time on impairments. The Group saw a further reduction in the impairment charge in the first half. The charge was 17% lower than in the first half of 2010, with higher charges in Ireland and Australasia more than offset by improvements elsewhere in the Group, particularly the substantial fall in the Wholesale division's impairment charge.

Impaired loans increased by just 1% compared to the year end, and now represent 10.6% of closing advances. The Group's coverage ratio over these is just over 45%. Both core and non-core impairments reduced and I will draw out some comments on this as I look at divisional performance.

Retail's impairment charge reduced by 12%, driven by the unsecured portfolio, and supported by improved new business quality, and a stable economy. And even though house prices remain depressed, our core credit performance remained strong, with the number of customers entering arrears lower than in the second half of 2010, both in the secured and the unsecured portfolios.

As expected, the secured impairment charge increased, which reflects the predicted movements in house prices. However, and also as expected, the unsecured impairment charge decreased, in fact by 32%, reflecting the improved quality of new business written over the last few years.

In *Commercial*, which we are reporting separately for the first time, the impairment charge decreased by 16%, as we saw an improvement in the overall credit quality of the portfolio. At the same time, the stabilisation of the economy and commercial property prices, combined with low interest rates, led to an overall reduction in the level of defaults.

The *Wholesale* impairment charge materially reduced by 44%, driven by the significant reduction in the non-core businesses impairment charge. The overall charge as a percentage of average loans and advances to customers improved significantly to just over 2% in the first half of 2011 compared with 3.11% in the first half of 2010.

The decrease has continued to be driven by the corporate real estate and real estate related assets, together with the stabilising economic environment in 2010 and so far in 2011, a low interest rate environment helping to maintain defaults at a lower level, partially offset, the charge overall, by increased impairment on leveraged acquisition finance exposures.

In *Wealth and International*, impairment charges increased by 14% on the first half of last year, predominately as a result of our Irish portfolio where in Q1 we anticipated further falls in commercial real estate prices.

I want to look at the headline trends in our Irish portfolio in more detail for a moment. Continuing weakness in the Irish economy resulted in an increase in impaired loans in the first six months of the year.

Provision coverage levels have been increased due to actual and, as I said, anticipated falls in property values as we have discussed and we now have a coverage ratio of 56%, up from 54% at the year end, and 42% a year ago.

Although the portfolio is non-core, and a dedicated UK based Business Support credit team is managing the wind down of the Irish book, current levels of redemptions and recoveries are low due to a severe lack of liquidity in Irish assets, a problem we do not expect to be resolved quickly.

As it is topical, I am now going to briefly comment on some Eurozone exposures. Our retail and corporate exposures are unsurprisingly dominated by our Irish positions.

Our Spanish retail exposure consists of secured residential mortgage lending. About half of this portfolio is to expatriates and the other half are local mortgages. The performance of these books is fine with average loan to value of about 63%, and about 5% of it impaired with a coverage ratio of about 30%. The Spanish Corporate exposure is mainly local lending, comprising Corporate loans, project finance and some commercial real estate. The corporate loans and project finance books have seen only modest impairments, 3% in fact is impaired, whilst the CRE book which is only about £400 million in total, is 22% impaired with a 49% coverage ratio.

The Corporate exposure we have in Greece relates to loans to Greek shipping companies, where the loans are generally secured, and where repayment is mainly dependent on international trade rather than linked to the state of the Greek economy. So whilst we manage all of these exposures carefully, they are modest in scale, and we are not unduly concerned.

Looking now at exposures to sovereigns and local banking groups, more than 40% of these secured through either covered bond or ABS structures. The Group has minimal direct exposure to the sovereign risk of any of these countries, and this includes national governments and central banks.

The other 'Banking Groups' exposures shown here are mainly short term money market and trading exposures, or money market lines and repo facilities to some of the major banking groups in Spain and Italy. The counterparties are a limited number of well rated financial institutions with whom we have longstanding relationships. More details about this are set out in the news release this morning.

Now back to the UK and the performance of our UK mortgage portfolio in the first half. As expected, the secured impairment charge increased, reflecting less favourable house price forecasts. Pleasingly, the proportion of the mortgage portfolio with an indexed loan-to-value of greater than 100% improved slightly to 12.2%.

Perhaps more importantly, however, the value of the portfolio with an indexed loan-to-value greater than 100% and more than three months in arrears also improved slightly by £0.1 billion and is now £3.1 billion, still less than 0.9% of the portfolio.

Let me also give you some insight this morning on forbearance activity. We are of course encouraged by our regulators to treat customers in financial difficulties fairly, and forbearance rightly plays a key role in achieving that. Forbearance is also an important tool in actually mitigating financial losses from impairment events, as all observers would I am sure agree. We apply forbearance under strict conditions and forbearance activity in our portfolios is therefore limited and well controlled. Where there is forbearance, the asset continues to be reported as past due or is considered impaired depending on its arrears status. As a result we are confident we are currently appropriately provided on accounts where there is forbearance.

As you can see from the charts behind me, the number of new cases of forbearance has seen a steady reduction over the last couple of years, and in addition the number of mortgage customers new to arrears decreased again in the last six months. All in all, we continue to be satisfied with the performance of these portfolios.

Let me now take you through the profile and the management of the non-core businesses, which as you know excludes Verde. We are pleased with the progress made on our balance sheet reduction plans in the period, given challenging market conditions in the first half. On 30 June, we updated our strategy to reduce the non-core portfolio, and we set a new target to reduce the balance to be equal to, or less than, £90 billion by the end of 2014. In the first half of 2011, we achieved a substantial reduction of the non-core portfolio of over £30 billion, resulting in the portfolio now amounting to £162 billion.

We expect the remaining book to account for less than or equal to £65 billion of risk weighted assets by the end of 2014. And as you know, we are also targeting non-core run-off and disposals to be net capital generative over the period 2012 to 2014. And I want to talk more about that specific point in a second.

But first, let me look briefly at the continuing de-risking of the balance sheet. Group risk weighted assets reduced by 6% in the first half, driven by the run-down of our non-core asset portfolio, strong management of risk and appropriate risk criteria for new business.

We expect further modest risk-weighted asset reductions in the second half of this year, however we expect these to be offset by the effect of the implementation of the CRD rule changes, and RWA's will therefore be broadly flat from now until the year end.

Let me go back to the full non-core business now and look at its overall performance..The 51% fall in non-core underlying income was primarily driven by the losses on asset disposals in the first half of this year. But remember the fair value offset. Excluding these losses, non-core underlying income decreased by 16%. The non-core margin also decreased, primarily as a result of higher wholesale funding costs and the income drag effect from increased impaired assets.

We have been rigorous on how we allocate the operating expenses to non-core, only considering an expense as non-core where we have a very high level of confidence that we can manage the expenses down as the assets go down.

The non-core impairment charge reduced, principally as a result of a material reduction in the Wholesale impairment charge, and partly offset, as we have noted already, by an increased impairment charge in International, which principally relates to our Irish portfolio. Even though we have seen lower non-core income, the reduction in costs and in impairment charge led to an improvement in the non-core loss of 25%.

I thought it would be useful at this stage to give you an illustration of the capital and funding benefits generated by our management of the non-core book.

Despite the continuing impairments and the reduced margin in non-core, the run down of the non-core portfolios in the first half has been close to capital neutral. The capital consumed by the loss after tax in the non-core business has nearly been offset by capital released by the reduction in risk weighted assets from their disposal and the adjustment in excess expected losses. But the progress made has further reduced the level of risk in the balance sheet, and in addition we have achieved the obvious and substantial funding benefit from the run off programme.

As I said, we target non-core run off being capital generative over the 2012 to 2014 period in aggregate although not necessarily in every reporting period.

Moving on now to our capital, liquidity and funding. I am going to do liquidity for a second. Our core tier 1 ratio now stands at 10.1%, reflecting the effect of the statutory loss, partially offset by a reduction in risk-weighted assets of £23 billion. As you can see, the business generated about 50 basis points of ratio improvement in the half, albeit this was absorbed by the PPI provision that we took in Q1.

On 30 June, I also spoke of planned further capital restructurings which would reduce the total core tier 1 deduction under full Basel 3 relating to our insurance operations by about £2 billion. That has now been completed, achieving significant mitigation equivalent to about 50 basis points of core tier 1 ratio under full Basel 3 and reducing the transitional rules impact from insurance to approximately 20 basis points per annum.

We made excellent progress on our term funding issuance plans. In the first half we achieved £18 billion of publicly placed term issuance, and in addition a further £7 billion of term funding via a series of private placements. We continue to expect to issue new funding between £5 billion and £10 billion over the second half of this year across all public and private, secured and unsecured issuance programmes and in aggregate.

During the half, the absolute level of Group wholesale funding fell by 1%, despite the strong new term issuance, reflecting first half maturities. Successful new issuance also allowed the Group to maintain its maturity profile, with 49% of wholesale funding having a maturity date greater than one year despite, as you can see, a significant volume dropping into the less than one year maturity bucket.

Turning now to the reduction in government and central bank funding. As we have said already, the Group achieved a reduction of £60 billion in the first half of this year leaving just £37 billion outstanding at the half year. The liquidity support from the government and central banks have various maturity dates, the last of which is in October 2012, and current plans assume that the remaining facilities will be repaid in line with contractual maturity dates.

As Antonio said, we have also been successful at further improving our loan-to-deposit ratio.

By the end of the first half, our loan to deposit ratio, excluding repos and reverse repos, had improved to 144%. We also further reduced our core business loan to deposit ratio to 114%. This reduction is partly due to the continued customer deleveraging and subdued new lending demand. But at the same time, we have successfully grown total customer deposits by 3%, reflecting good growth in relationship deposits in Retail and in Wealth. We continue to work towards a Group loan-to-deposit ratio of 130% or below by the end of 2014.

So let me now summarise the material aspects of our first half performance, and also reiterate our guidance for the full year.

Our view on 2011 is broadly unchanged. We are continuing to see various pressures on our net interest margin, as I have said, but despite these effects, we are still targeting a net interest margin of just above 2% for 2011.

As a result of increased margin pressures we have seen a reduction in income and we clearly expect a further slight reduction in core income.

As a direct result of cost actions taken in the first half, we continue to expect costs to reduce slightly this year, and we remain on track to deliver our target integration cost synergies of £2 billion per annum by the end of the year.

We have seen a good reduction in the impairment charge, as improvements in Wholesale and Retail more than offset the further deterioration in impairments in Ireland. Our overall impairment guidance, and the division by division comments, remain unchanged.

Additionally, we are very pleased with the non-core asset reductions in the first half... Together with excellent progress on our term funding issuance plans and our deposit growth, this has enabled us to pay down material amounts of government and central bank debt. And lastly, of course, we have seen that very strong improvement in the loan to deposit ratio, which now stands at 144%.

In summary, the Group's performance in the first half of this year was in line with our expectations and guidance and we are making good progress towards our medium term targets. And with that, I will hand you over to Kate who is going to help us organise question time. Thank you very much.

End of Presentations

<u>Question and Answer Session</u>

<u>Question 1: Tom Rayner – Exane BNP Paribas</u>

Good morning, Tom Rayner from Exane BNP Paribas. Just looking for a little bit more colour Tim on the sort of trajectory now of the margin. I hear you have reiterated the 2014 target range. Guidance would suggest we dip below 2% in the second half or somewhere close to that. I think if you annualise the full year effect of some of the expensive issuance this year, that is another drag as we go into 2012. So I am just wondering, are we looking at a sort of U-shape or maybe a smile shape trajectory from here to 2014 on the margin?

Answer: Tim Tookey

Tom thanks for the question and welcome back. In terms of shape of the margin, I think you are thinking in a similar way to me. I am thinking that the second half margin will be around 2% and that will give us a full year margin of just over 2% which is consistent with what we were saying at 30 June. The annualisation effect of the items you were talking about. So repayment of central bank funding which as we all know was relatively cheap when we had it. And the wholesale issuance cost which will be relatively more expensive will continue to come through. So I do look at a smile shape in the margin, as you articulate. And what I think will turn that is unchanged from what I have been saying for several seasons now, well reporting seasons, which is that we will see movements in base rates and we will see lower new wholesale costs to us. Both coming from lower spreads as recovery sets in. But also, very importantly from lower issuance that we have to make. And I think now that we have much less issuance coming forward, it is easier for us if you like to look into that crystal ball at the impact of wholesale funding on our margin because the amount of aggregate funding that I have that is going to change, because I am going to issue new, is reducing, which gives me more confidence in the shape.

Further question

My second, I will keep it on margin so it is really only one. I wasn't quite sure from one of your slides, whether deposit, it sounds like deposits pricing has been a positive because you have been replacing even more expensive wholesale. But my impression is that deposit competition is pretty intense in the market. So I just wondered if you could comment on that going forward. And also within the wholesale, I know you have split out commercial now, but they looked like a fairly good margin improvement coming through in wholesale, but there was a comment about market value of deposits. I just wondered if you could explain what the trends there were please.

Answer: António Horta-Osório

Let me comment to you about the retail deposits and the deposit evolution. We are very pleased, as we have both mentioned that we have increased retail deposits by 3% in the first half, substantially above the market. And we think it is key in that behaviour the fact that we have a multibrand strategy which enables us to segment and have appropriate offerings to the different type of customer segments we have in the different brands. And to give you one example, one of the biggest successes we had was in the ISA campaign, through the Halifax brand, where as I said, we have provided a product that was not leading in price, but gave value date, of the day of the application which was from our research, one of the key points customers wanted and one of the key points of customer complaints. And therefore in the total ISA campaign we have a net market share of ISA ins. So all ISA's transferred into banks, we have a net market share of more than 30% although we were not being leading in price. So we think this is a very good performance in terms of volume. And also given that deposits stay with us in relationships, they are also better deposits in terms of costs, as you were saying than wholesale funding costs. So from both perspectives. And the multibrand strategy is key in this respect and having products for different customer needs.

We are also progressing well in corporate deposits where we are providing lending as customers want, but as you know customers are deleveraging on the back book. And the relationship managers in the different corporate segments have been very focused on getting relationship deposits which have also been progressing well. So this is a global picture between the two segments and this is a critical point in bringing our loan to deposit ratio down 10 percentage points in only six months. And if you look at our core book, our core business, we are now within the range that we want of a loan to deposit ratio below 120%

<u>Question 2: Joe Dickerson – Espirito Santo</u>

Hi it's Joe Dickerson from Espirito Santo – I just have two questions. First of all, I was wondering if you could. You mention the expense of H1 issuance and wholesale funding. I was wondering if you could quantify say the impact in basis points relative to the second half of 2010 in terms of the increase in costs so that we can think about that for the margin as we go through the rest of 2011 and into 2012.

And the second question I have is just if you could provide some granularity. When I look at the net interest margin in the retail business, it compressed more than I thought. And I was wondering specifically if you could comment on what is happening on the asset side of the margin there and if you can see any competitive pressure say on prime mortgage, and what the general trend has been on the asset side? So again we can think forward on that number. That's all, thanks.

Answer: Tim Tookey

We don't get into the level of granularity I am afraid, to answer the first part of your question on the issuance costs of what we did. But with 18 of the 25 having been public, I daresay somebody keen to do the research could work out if you could like 18/25ths of it. When I talk about it being relatively expensive, it was certainly more expensive than we had anticipated at the start of the year issuance would be. But actually when I look at it today and I am actually very grateful that I don't have to be in the wholesale markets at the moment. To only need to do 5-10 for the rest of the second half of the year because a very good position in which to deploy our needs and select the programmes and the structures and the tenures in the market that we would need to access in the second half. So I don't get into that level of break out of funding. But it is of course fully embedded in the margin guidance that we are giving for the second half and the full year.

António Horta-Osório

Sorry would you mind repeating the second part?

Further question

The second part of the question was on the retail net interest margin and specifically what is happening on the asset side of the net interest margin in retail? In other words is there any competitive pressure on the asset side say from prime mortgage etc?

Answer: António Horta-Osório

Our new business pricing continues to be above the stock price. So it has a positive trend there. But when you look at retail as a whole, we have still a loan to deposit ratio of higher than one. And as the wholesale cost of funding is more expensive, that effects the margin that we have in retail overall. But I repeat we continue to have better assets new business pricing than the stock price with a positive dynamic there. You have a negative dynamic in terms of savings in terms of new business versus stock, although the new business pricing is better than our wholesale term funding. And what is impacting the retail margin as a whole is the cost of the wholesale funding, even though our loan to deposit ratio is shrinking, it is still higher than one.

Answer: Tim Tookey

I think I might add something. I will actually agree with what Antonio has said and that gives you the dynamics of what is happening in there. But I understand your point about it perhaps moving more than people had expected. Remember perhaps that what we said back in February was that we had a certain amount of funding costs for the whole business that were left in the centre. And so we have actually changed marginally, wrong word margin. We have actually changed slightly how we are allocating costs around the Group in order to reduce the amount of unrecovered costs from the centre. So that dynamic also comes through in some of the divisional margin analysis that you have.

But my focus is really on the Group margin and that is where we have seen the dynamics in play. We have seen the expansion of margins over previous periods and now we are seeing the impact of the necessary repayment of central bank funding and wholesale funding come into play. So my focus really rests on where the Group margin is going, and that is where I am actually very pleased with the performance we have had in the first half. I hope that helps.

<u>Question 3: Manus Costello – Autonomous</u>

It's Manus Costello from Autonomous. In the adverse scenario of the EBA stress test, you reported a cumulative loss on your commercial real estate portfolio of about 14% which was pretty much the worst of the 90 odd banks that reported and in today's Release you talk about concerns that the trends in that market are deteriorating again for your portfolio. I wondered why is that portfolio still so fragile relative to peers, given the level of impairment you have taken on it already. And what are you doing to mitigate that?

And I had a second question as well which is that you have just posted and are likely to post a significant statutory loss for the year. I wondered if that was going to impair your ability to switch back on hybrid coupons next year.

Answer: António Horta-Osório

Okay, let me start with some general comments and then I will pass on to Tim. We are very comfortable that the level of provisions that we have in the different credit portfolios is appropriate. Second, we have the largest retail and commercial bank in the United Kingdom and we see no material change in trends in terms of the different portfolios and in terms of the impairment trends. And we are the largest bank in this country. I want to be very clear about this, that we are very comfortable, that the level of provisions in the different credit portfolios is appropriate and we see no material change in the trends.

Okay. Now I will ask Tim to comment specifically on those two questions.

Answer: Tim Tookey

Yes, thank you very much. I think it is important to remember that the EBA stress test uses a defined set of stress criteria. So then there is a mathematical exercise that applies those to a book. I can't remember exactly, I am going to look for a nod on the front row on this, but I think the EBA stress test required us to have a 36-38, 36% fall in commercial real estate prices to be assumed. So that is you like is something that is a feature of the stress test. So I think against that, actually where we came out in that stress test I was very satisfied with.

I think the other comment I would add in terms of trends, I am not quite sure you should take away that we are concerned about commercial real estate and I actually echo Antonio's comments there. Indeed commercial real estate was one of the biggest drivers of the improvement in the wholesale impairment charge. So that has been the dominating fact in reducing the wholesale impairment charge. So if there is something left in there that concerns you I would be happy to have a chat afterwards.

Further question

And on the ability to turn back on hybrid coupons next year?

Answer: Tim Tookey

I don't think the loss. You are coming back to the statutory loss point. I don't change my position on that and the answers that we gave to questions on 30 June because of course the loss you are referring to was something that appeared in the first quarter and therefore was factored into what we were saying in terms of future guidance as part of the strategic review.

<u>Question 4: Asheefa Sarangi – RBS</u>

Asheefa Sarangi, RBS. I just have two questions. I noticed in the commentary there wasn't really anything on IAS19 or the need as of January 1, to recognise the unrealised actuarial losses of £159 million by that date. Should we be thinking about that coming out of the tangible book over the next few periods?

Also with respect to CRD4, we were thinking that you would fall under the regulations side of the equation and therefore you would fall under the financial conglomerates directive which would be beneficial for the insurance deduction, but we see no mention of that within your statement and I was wondering if you could comment on that?

Answer: Tim Tookey

Shall we toss for that one? Can I do it in reverse order? On the FCD, I think I read what was written in the CRD4 draft that came out in the middle of July and I have seen some commentators, mainly European ones, look at this and say, hang on a minute this FCD route to a slightly more beneficial treatment of bancassurers looks like it is still open. My interpretation is slightly different. And I don't actually believe that that route will really either remain open or if there is a route through it, it may be a continental route through to it rather than a UK allowed route through into it. So at the moment I would love to be banking the benefits of that, but I am not and hence, why I am especially pleased to have further mitigated since 30 June the Basel 3 insurance impact on us.

As far as IAS19 is concerned, what you are referring to there I think is the expiry of the pension corridor accounting which is indeed coming down the track in a couple of years time. Wherever we get to in terms of the deficit of that time will have to be brought into the IAS19 or revised IAS19 compliant treatment. So yes mechanically it would fall into net tangible assets. Although I would hope by then that we had a positive progress and perhaps more than the NTA for share progress we made in the first half.

Further question

I am going to be naughty and just ask one more question. On the German litigation risk that you pinpoint as being potentially significant, the number of things that have come through that seem to be potentially significant are in between £500 million to £1 billion of late. Is that what we should be thinking about? I know you are not giving a direction on timing, but should that be coming through over the next 18 months do you think?

Answer: Tim Tookey

This is an early disclosure we have made of a particular item. What we have got here is a small handful of individual complaints that have been made about closed book sales of a German operation. What we have had is a German regional court give here a couple of decisions which have surprised us. And therefore we felt it was appropriate at this stage to make a disclosure although we are continuing to take legal advice on how we progress this, but it is very small at the moment.

<u>Question 5: Rohith Chandra-Rajan – Barclays Capital</u>

Thanks, good morning. Rohith Chandra-Rajan from Barclays Capital. A couple of questions on impairments if I could please. The first specifically on wholesale. You highlighted some very substantial drop year-on-year in wholesale impairments, but if I look at wholesale versus the second half last year impairment is up 20%. And looking at the quarterly disclosure, 2Q versus 1Q looks to have doubled. You mentioned low recovery. I just wondered if you could provide a bit more clarity around that. So that is the first one.

And then the second point also on impairments. Really just kind of revisiting your guidance which as you say is unchanged at a reduction in the impairment charge year-on-year. Looking at the guidance division by division, you talk about modest declines in retail and wholesale sort of fairly flat in commercial and down in wealth and international. Just sort of factoring in some sort of 10% declines for retail and wholesale and maybe 15% for wealth and international would get you to an £11.5 billion impairment charge for the full year. So a pick up in the second half. I am just wondering if you could comment on that analysis please?

Answer: António Horta-Osório
Okay I will start and then ask Tim to make some comments as well. The wholesale portfolio contrary to commercial or retail portfolio are more lumpy. The wholesale portfolios are more lumpy. So when we look at the results are in line with what we expected. As I said, we don't see any substantial, any material change in terms of trends. And the fact that it is in wholesale you have lumpier movements from quarter to quarter. And in terms of our retail portfolios, where the trends in commercial are much more clear you have a much more linear trends.

In terms of our overall guidance, we are not providing guidance for impairments for the second half of the year, but we have provided guidance for the whole of the year where we continue to expect impairments to be substantially down year-on-year. And now Tim maybe you can comment a bit more detail please.

Answer: Tim Tookey
Yes certainly. I actually agree that the wholesale by nature is going to be lumpy. And therefore there will be movements quarter on quarter. I think I would prefer to continue with quarterly reporting on the basis of improved transparency should be good, but one has to understand that with that will come some lumps and lumpy movements. I also made reference Rohith in my prepared words to some additional provisions we had taken on, some of the leverage exposures for example and that is a feature of the second quarter. But if you look underlying this, not only is the actual full year guidance unchanged, but also the performance of the core book continues to be very strong indeed. If you had the time to look, I think it is about page 47 or 48 of the news release, you will see there that there is about £79 billion of core lending in the wholesale division and we have taken impairment charge of about £400 million. And that is a very solid performance indeed.

I think the other comments you made around recoveries. I mean to me recoveries are always a bonus. And the fact that I have low recoveries in the first part of this year still means I am having recoveries. And I guess I look at it and I say to myself, what that tells me is I have further evidence that my impairment provisions are appropriate and my marks are sensible. And we are managing the exposures that we have in a very measured and balanced way. We have made good progress in the first half of this year on non core disposals as you have seen. And that has given us significant funding flexibility. So overall I am very pleased with the performance.

Further question
And just in terms of the interpretation of your divisional guidance, so modest equals a 10% reduction, further reduction for the wholesale, sorry wealth and international maybe 15%. Is that the right ballpark to think about, that sort of level of reduction year-on-year?

Answer: Tim Tookey
Well I would go back to what Antonio just said which is the guidance we give is full year versus full year. And the guidance we gave in February and that we reiterated again at the end of June stands. So I think the word modest is the same word that I used back in February and we used in June. So I am not going to get drawn into whether the first half can be interpreted as defining the word modest. Okay I am sticking with where I was full year and full year and I am very happy with that. I think where you extrapolated it to though did concern me a little bit. I think you said that if you take all of your maths and I couldn't write it down fast enough, you ended up at something about 11.5 for full year impairments. I think if you had that in your model than you are way above where consensus for impairments is which is from memory is a high 9 in terms of, for example. 9.6. A mid 9. Now I am not going to answer your follow-up question which is, am I happy with consensus? But what I can tell you is I have some concerns about people who are modelling it at either end of the spectrum. And if you wanted to interpret that in one particular way, then that is up to you. But this is being recorded and I am not allowed to say any more.

Further question
Thanks, and consensus would be 27% down year-on-year?

<u>Question 6: Chris Manners – Morgan Stanley</u>
Morning everybody, it's Chris Manners from Morgan Stanley here – just a couple of questions. The first one was on the capital and insurance division. If you take £2 billion out, firstly how will rating agencies react to that and does it matter? Secondly if you are going to be doubling your revenues in bancassurance, won't you need more capital rather than less in the division?

And the second one was on the funding. Obviously the funding market is very tricky at the moment and you are saying you need to issue £5-10 billion for the rest of the year. If the markets remain as hard as they are at the moment I mean could you consider not issuing any more term funding for the rest of the year and running down your liquidity buffer? And if so, how far could you take that down and remain comfortable? Thanks.

Answer: António Horta-Osório
Thank you for your question. I will start the third one and then I will ask Tim about the first ones. In terms of funding, I think what we did on the first half of issuing £25 billion well ahead of our initial plan while the markets were opened, number one. And reducing more than £30 billion in terms of non core assets number two. And number three, increasing deposits by 3% on the six month alone is a clear indication of how robust and how much stronger our funding position is. That is why Tim said we only need within our original plan to issue between £5-10 billion. But we are going to continue within our plan of having capital liquidity in terms of how we will continue for the future to decrease non core. We are in a much better position after having decreased more than £30 billion in six months alone. We are in a very good position also to choose when to issue even that we only need to issue in our plan between £5-10 billion. We are continuing to progress in our deposits. So we are quite comfortable with the funding position and I think with hindsight it is even more justified what we did in the first half, because as you know, the markets have been shut for the past two months as you correctly point out. And in terms of liquid assets, apart from having £100 billion, £101 billion to be exact, £101 billion of primary liquid assets, we have on top of that secondary assets and income that we can use at any point in time. So the two together if you look at RNS, we have £218 billion of primary and secondary liquid assets so we are in a very, very robust position.

Answer: Tim Tookey
Shall I comment on the insurance bit? I mean the restructuring I referred to, you shouldn't read as a repatriation, it is a restructuring of the insurance in that division. And obviously we have considered and discussed and shared it with the rating agencies. And I am not expecting any issues from that that will cause anybody any concern at all. The capital structure in our insurance groups is perhaps now slightly more in line with some of our competitors rather than all being virtually provided through common equity. So if you like, we are normalising something and that is a sensible way to mitigate the impact of the forthcoming Basel regulations. In terms of what does that do to the capital levels? On page 73 of the new release you will find the IGD surpluses of the two insurance businesses. One of them is £1.2 billion and the other is £1.7 billion. I am sorry I can't remember which way round they are for Widows and HBOS. But they are very strong IGD surpluses in those businesses.

In terms of the impact of growing bancassurance business going forward, I would have to refer you back to the slide that we gave in February which showed the increased capital efficiency of new product sales, where I mapped out the much reduced capital strain from the redesign of products that has taken place in the bancassurance offering that was launched in July of last year and that is a good indication of the capital efficiency improvements we have made in those businesses. So that is a very strong position.

Question 7: Michael Helsby – Bank of America, Merrill Lynch

Thank you, it's Michael Helsby from Merrill Lynch – I have got three questions if that is alright. One is a quickie. First of all, on your non core run-off costs that you have allocated, how should we think about those costs running down? Should we think about them running down in line with assets or is it going to be a lot lumpier than that? And also is there a double counting of those costs within the simplification? Because you hadn't broken out the non core when you produced the strategy day. So that is question one.

Question two is pretty much around the fact that you have got very substantial deferred tax assets clearly at the moment. You have got zero expected loss. I think there is a bit of confusion certainly around because you have said that you expect a £4 billion expected loss deduction from Basel 3 and I am wondering if there is a bit of double counting going on with DTA. So should we think about the DTA balance and the expected loss kind of running in parallel together?

And then finally, I just want to clarify on dividend policy. Now I know this is quite a way off, but I think this is quite important. When you think about dividends and I know you are not going to be starting them just round the corner, but should we be thinking about dividend policy on a transitional Basel 3 basis or should we be thinking about dividend policy on a fully loaded Basel 3 basis? Clearly it makes a hell of a difference in terms of timing. Thank you.

Answer: António Horta-Osório

In relation to the non core costs. We have only allocated to non core the costs that are directly related with the business. Okay. So the costs that will go down according to our plans up to the end of the run-down of the specific assets. And those include both the rundown of the assets and the simplification programme that we have presented to you. So there are no non core costs which if you want are not directly related to the non core and other of the assets. So we don't have non core costs allocated there which will then be sticky in the end, which I believe is your question.

Further question

So are those non core costs tied up with your simplification process? I think you just said that they are.

Answer: António Horta-Osório

Yes, they tie up to our total cost projection until the end of 2013 as we have shown on 30 June.

On your dividend question, what we said on 30 June is what we can say at the moment. We will wait for regulatory clarity in terms of capital requirements and we will resume our dividend policy when we have clarity and our capital requirements will be presently met. So we cannot say more at this stage. We know how important the decision is, we are also committed to doing that, but we do not have clarity at the moment to be more specific. If you want to comment more on this?

Answer: Tim Tookey

No I think we need further clarity from the regulators on where they are going to be on this going forwards. And of course I would love to think we will get that in the coming months, there is a big G20 and Basel Group meeting in November out of which we may get some more smoke, hopefully of the right colour.

I think your second question was around tax and expected loss. I think you were there talking about again Basel 3 impact, is that right? Well as I said back at the end of June with the Strategic Review Announcement, we obviously may have an impact in the Basel 3 transition from any deferred tax assets that are still on the balance sheet when we get into that time. And obviously that is a factor of future profitability. So one would hope they will be somewhat smaller than they are today for example.

As far as the excess expected loss, there is quite a complicated interplay in here with how fair value works. But I absolutely stand by what I said at 30 June. And you are right to recall therefore there is about a 20bps, i.e. £4 billion roughly 1% core tier 1 spread over five year, 20 bps per annum.

<u>Question 8: Robert Law – Nomura</u>

Robert Law, Nomura – could I have three as well as Mike got it? Firstly, in the area of capital release from non core run down, I note you don't make that commitment for the current year. Could you comment on whether you expect non core run down to be accretive for the current year and if not what kind of non core risk asset run down you have in mind for this year? That is the first question.

Secondly, what are the fair value balances now? I can't see them in the Release, but maybe they are?

And finally, the area of liquidity. I realise obviously you are restructuring the balance sheet to reduce this, but can you give us some indication of how much higher your liquid holdings will have to be at this point if you implemented currently proposed Basel 3 LCR requirements? Thank you.

Answer: Tim Tookey

Shall I kick off? Let me first comment about non core. I think we ran down, I am trying to remember now. I think it was about £23-24 billion in the first quarter and we are saying £31 billion for the first half. So you can see there that even that has an element of different pace in what can be achieved. The amount of non core run off still to do to our target of £90 billion or less is about £70 billion. And there is three and a half years to go, which would imply if you straight-lined it, and I am not suggesting you model a straight line, about £10 billion per half. You can see what we have achieved in various halves has been you know uneven and consistently uneven. And I think what this reflects Rob is our policy here which as we set out in June, is about balancing the trade-off between the funding benefit that you have from the run off versus the capital either consumption if you take a loss on selling versus release from the RWA disappearing. And of course all of that has to be balanced with the risk that is inherent in whatever asset you are saying. So I don't therefore project a figure for non core run off for the second half. But I do expect it to be, we are not going to do another £31 billion if that is what you are thinking, not by a long shot. In terms of whether it will be capital general restructure in the second half, I don't know, we will take a view as each opportunity comes along. What I would like to do is be, and this is our target, is to be cash generative over the 2012 – 2014 period. But as I said in my prepared words, I don't say that I am going to do that in every reporting period, because it will depend on the balance of liquidity, risk. You know there are two legs to this, capital destruction through the income statement is just one part of it. Capital release from the balance sheet side is equally important. And even at the end of 2014, you know we are likely to have you know £6.5 billion odd of core tier 1 tied up in our non core portfolio really delivering not a great deal indeed. So nurturing the capital out of non core is a very important part of what we want to do because it will give us huge flexibility into the future.

Further question

Yes and that is the reason I am asking the question because obviously you are putting some kind of floor under the prices you expect to get in the 2012-14 period but you know.

Answer: Tim Tookey

Then I'd like to still be making recoveries on what we sell. I think that was just one part of your question.

Answer: António Horta-Osório

I think it is important to mention for example. When you say the first half where it was broadly neutral, that you have to take into consideration that a big portion of the assets that we sold was not for capital reasons, it was because of the liquidity progress. And those assets some of them in terms of treasury assets are much more relevant in terms of liquidity, in terms of risk weighted assets you see. So you can see the focus and the attention we are having on a non core portfolio on the first half of 2011, where in spite of liberating more than £25 billion in terms of liquidity we have been broadly neutral in terms of capital generation with this secondary target of improving the liquidity position of the Group as we just discussed. So that is the type of mindset we have in addressing this. And going forward, as Tim just said, in terms of needs of selling for liquidity considerations, we are going to have a very different profile, given what we did prove with hindsight in half one.

Answer: Tim Tookey

I think the other part of your question was on liquidity levels. Honest answer Rob is I haven't done the maths to see what I would need today if I had to comply with everything that isn't coming in for the future. Indeed NSFR is 2019, LCR 2015. So all this is into the future. What we said on 30 June is we intend to meet both the ratios by 2014 and as part of getting there we would expect to see liquid assets rise. And I would expect overall liquid asset levels to be roughly equivalent to our less than one year maturity wholesale funding at that time, which will be less than it is today. So I guess from that you can derive the tram rails within which the answer lies.

Further question

And the fair value balance is now?

Answer: Tim Tookey

I haven't got a stock figure for that in my head. What you will find though that the best place to look for it is within the credit risk disclosures which are broken out by business area, which is about two-thirds way through the back of the news release, you will see the impairment. The fair value item that related to impairment which is the principle levels and that is broken out by division. The other main element is what is left on the fair value of HBOS own debt which has a long tail. In fact if you look in the core business results you will actually see fair value unwind there as a small negative and that is because that is the bit that relates to HBOS own debt and of course we would regard the debt as supporting the whole balance sheet but only allocate to non core, that would manage to zero.

<u>Question 9: Garry Greenwood – Shore Capital</u>

Garry Greenwood at Shore Capital. I just had a question on sovereign macro risk related to Ireland in particular. There is a lot of concern at the moment about the risk of a breakup of the Euro. And I was just wondering if you have considered the potential impact on the business if Ireland was to come out of the Euro and devalue its currency and whether you have got any contingency plans in place for that scenario?

Answer: António Horta-Osório

Well we were very, very mindful of giving you full disclosure in terms of all the countries, so you have in there a summary of our disclosures in terms of Ireland, Portugal, Spain, Italy, even Belgium in terms of the different types of securities and in terms of the different types of assets. On the Irish specific risk that you mentioned, of course if Ireland left the Euro which we think is a really remote probability there will risk in terms of foreign exchange as you say because we have assets in the country and we don't have deposits in the country. Which is a risk that we monitor, that it is included in our risk appetite and that we are cautious about, but it is a risk which you have to consider but that is not touched upon. You cannot hedge that type of risk. So you can consider the probabilities, but it is a risk that you cannot hedge as you cannot hedge in any other country.

Further question

How would you react to it if it happened?

Answer: António Horta-Osório

We think it is a really an extremely remote probability in terms of that happening. We are not at all thinking that that might happen. Although in terms of our risk appetite and different scenarios, we have considered that risk and we know it exists. But it is a risk that is given. There are no liquidity in terms of assets in Ireland, there are no transactions, the portfolio is run down according to time. And you know that we have already provision 56% of the impaired assets, but that is a risk which does not have many levers at the moment. If you want to comment?

Answer: Tim Tookey
No, I agree with that. I agree with that.

Answer: António Horta-Osório
And that risk is the same to any other country you might want to consider.

<u>Question 10: Jason Napier – Deutsche</u>
Good morning, it's Jason Napier form Deutsche Bank. Two questions please. The first just goes to the increase in the expected loss deduction under core capital. I take the commentary that suggests that is primarily because of sell down of higher provision assets, but at £1.2 billion across the capital base, it is you know 20 basis points of loans. It feels like a big number. And I just wondered whether you could talk about whether there is any inference at all about changes to your own view on terminal loss in the portfolio and whether that deduction might increase as disposals continue?

And then the second question just on deposits. I know for the NIM outlook you have sort of confirmed that base rates and prefs, cheaper wholesale funding will drive you to the target over time. I just wonder whether in the deposit market you are modelling any kind of change in deposit cost spreads and/or mix just noting that your international online balances were up nearly 100% in the last six months. It doesn't feel like a market where you know price can be anything other than very keen if you are going to attract those sorts of balances? Thank you.

Answer: António Horta-Osório
I will start with the second one and then Tim will answer on the first one. We believe as you said that as base rates start to increase as they eventually increase by the end of the year, or into early next year, we will have an impact which is both on our savings balance and also on our current account balances which have different types as you know, of reaction to base rate increases. So it is the two effects that will drive our profitability going forward from the liability point of view in the next few years. We are having very good behaviour in terms of retail deposits as we just discussed, through the multibrand strategy and attracting specific, this was a Halifax brand, significant deposits not being price lead. And also as you mentioned, our international wealth, in our international wealth businesses we have been having very good success, including online deposits. On attracting deposits at good prices and significantly lower than our wholesale cost to funding. And the two impacts together, seamless presentation is what drives the mixed change in terms of the costs of liabilities which we expect to continue.

Further question
So to clarify, the international deposits are also cheaper than the stock of wholesale that you are refinancing?

Answer: Tim Tookey
Yes they are.

Jason I will pick up on your second point, but Rob on fair value, we have found, it is page 28 right at the back of the appendices you will find the annual fair value unwind table that we have set out as usual and you will see there in the tail of that, in the outer years, that will recur for a few years which is the own debt unwind bit which is bang on what I said it was about £300 million. I hope that helps.

Jason, EEL I think you were asking about. I think naturally over time, we will see an increase in excess expected loss. So yes I agree with your analysis, because what will happen here is we will see an improvement in the portfolio. So we will see a reduction in the actual impairments we are taking, but by definition if you are taking less than the excess of the expected loss that you would see comes out of the model over what you have actually provided would increase. So yes I would expect that to increase over time. That is one of the reasons I wanted to give transparency on where I thought it would get to by the time we get into Basel 3 and the start of transition, which we did in June.

<u>Question 11: Peter Toeman – HSBC</u>
Peter Toeman from HSBC. Just coming back to the margin again. Thank you for giving us the numbers on the core business and the margin is 2.35. But on your own numbers by 2014 this could be down to I think 2.10 on your three year forecast. Everything you said about deposit behaviour, lower issuance, cheaper cost of issuance is a positive, so what are the negatives that you have got in your 215 basis point margin assumption?

Answer: Tim Tookey
Peter let me help you out. The margin guidance that we have given is actually for the full Group. Whereas which was a range of 215 to 230 bps by 2014, but the Group margin would be lower than the core margin. So I don't recognise the 210. The bottom of the guided range is a 215 by 2014 and it is a Group margin. And I would very much hope and believe we will continue to see the trend that we see now, the core margin being some way higher than non core. Does that help you?

Further question
It is just that the non core assets run down so the trend of the margin should be closer to the core rather than a mix of the core and non core?

Answer: Tim Tookey
Yes, over time, although sadly I will still have about £90 billion of non core assets by the end of 2014. I would love it to be lower and inevitably, some of those will be poorer returning assets. Remember that we actually calculate our margin on a gross basis, so when I refer to income drag in the margin, it is because I am still reporting our margin over gross assets and therefore the more impairment that we take on non core assets I get more of a margin drag, just because of the way it is calculated. I think it would be, I don't think it would be right to switch to doing it on a net basis because I would get an artificial boost in the margin which really wouldn't reflect what I would think would be a fair and reliable trend.

<u>Question 12: Mike Trippett – Oriel</u>
Morning, Mike Trippett at Oriel. I just wanted to ask you about the average risk weighting. The comments you have made about excess expected loss, does that same calculation drive up the risk weighting now from where it was in the disclosures at the end of last year?

And secondly, what is your understanding of the project Verde process if the Banking Commission makes a firm recommendation for an enhanced investment?

Answer: António Horta-Osório
Let me start with the second one on Verde. We have as we discussed this in June here as well. In relation to Verde and the ICB, we started the Verde process in March because in our opinion the timetable was short and was not if you want, we did not have a lot of leeway to have to the end of 2013 to do not only the negotiating process, but also the separation and completion of the sale. In our opinion, let us just start immediately, point one. Secondly related to that, as we finished our integration process, we are liberating a lot of experienced resources that we can use in terms of together with the buyer, running the completion of the transaction. So these two reasons together were why we planned the start of Verde already. How is the process in terms of Verde? We have received a number of credible bids, we are analysing those bids. This is quite a tailor made process from now onwards with each of the bidders and we continue to expect to be able to find a buyer by the end of the year as per our original plan. In similar time, as you were saying, we have engaged with the ICB, first a preliminary report, and we are continuing to engage. We have had a good and

sensible dialogue with the ICB and we are progressing and we will continue to engage ahead of the final reports. I am sorry I can't tell you much more at this stage, but I think we are well aligned in our plans of tying these things together.

Further question
But if there was an enhanced investment, the process has to be delayed surely and that doesn't comply then with the EU?

Answer: António Horta-Osório
Well substantially enhanced has not been defined. We have worked substantially since the preliminary report in enhancing the balance sheet and the availability of funding lines to project Verde, to the assets we are going to sell. And I repeat we have had good and sensible dialogue with the ICB which we will continue to have until the final reports. So we do not foresee delays on our process of finding a buyer for Verde until the end of the year. You also know that the buyer at his own option, the buyer at his own option can choose to buy less mortgage originated less intermediary originated mortgages and have a smaller balance sheet with the limit of the loan to deposit ratio of our retail business. So we do not foresee for example, that the numbers that have been seen in terms of funding up which were relating to the 2010 numbers and the broad balance sheet will present a problem for the several buyers we are speaking to.

Answer: Tim Tookey
Mike the first part of your question was on risk weightings I think. I think that any impact there would be outweighed by the benefit that we would see from weightings from the lower risk business that we are writing. And we are seeing the first benefit of that is coming through for example in the very nice drop in unsecured retail impairments. I know it is impairment charge, rather than risk weighting but it is indicative of the improving quality of new business that has been written. So we saw a small risk weighted asset reduction in the first part of the year, even from our core portfolio which is a good indication of improving quality.

<u>Question 13: Ed Firth – Macquarie</u>
Morning, it's Ed Firth from Macquarie and sorry I didn't particularly want to bring you back to wholesale impairments, but just looking at page 115, if you look at the non core wholesale book, your impairments are up almost 40% H1 compared to the second half last year. And yet your coverage ratio was actually down from 46 to 41. Now I hear what you say about it is a lumpy charge, but we are talking about £400 million of additional provisions there. So could you give us some greater guidance as to what is going on and why you are happy seeing your coverage ratio falling?

Answer: Tim Tookey
I am very comfortable with the coverage ratio. I believe the coverage ratio is an answer. The coverage ratio is what comes out when you have done an asset by asset assessment of what you need to take to reflect the reduction in the value you will derive from that asset. Also in the period, we actually wrote off some of the impaired assets that we had and those would have carried a weighted average higher level of coverage ratio. So if you actually look at the level of impaired loans on that same page 115, they are down from £27 billion to £25 billion, and part of that would have been write-offs. Some of it of course would have been recoveries and some of those recoveries would have been highly impaired assets where we were absolutely delighted to make a recovery in the period. So for me the coverage ratio is an output rather than something I use to measure the overall appropriateness. And that is particularly pertinent in a book like the wholesale book where we do that assessment on an asset by asset basis, looking at the cashflows we expect to flow from the exposure.

Answer: António Horta-Osório
That is the only way you can do it on a wholesale book. I mean coverage is quite important when you look at retail or smart portfolios when you can on a statistical basis, because it is based on statistical models. And

on the wholesale you really have to go asset by asset and see the recoverability of your impaired loans and then when you add it up you can have a different number. But as I told you, we are very comfortable that the level of provisions on our different credit portfolios is the appropriate one and you have to take into considerations as Tim just said, the write offs which obviously are done on a 100% basis in terms of loans and impairments.

End of Presentation