Lloyds Banking Group plc – Q3 2012 Interim Management Statement

Thursday 1 November 2012

António Horta-Osório – Group Chief Executive

Good morning everyone, and thanks for joining us for our Q3 results call.

I'll begin by giving an overview of the further significant progress we have made against our strategy.

So now turning to slide 1, for those of you who are following the website presentation.

The Group's underlying performance has significantly improved, in spite of a challenging environment.

Underpinning this is a very strong core franchise which is producing decent returns, significantly above the Group's cost of equity. But we are not complacent. We are on the front foot and are seeking further improvements through the initiatives we announced last summer at the strategic review. This includes our investment in customer service where Lloyds now has the highest NPS score of all the high street clearing banks and also FSA reportable complaints continue to fall, having fallen by 42 per cent over the last two years.

We are also continuing to make good progress in strengthening our balance sheet to support these core returns and lower its volatility, while de-risking the business by reducing the negative effect from the non-core and ultimately lower our cost of capital.

I am of course disappointed that legacy issues, especially PPI, continue to weigh on the bottom line, however, more broadly, our sustained progress means that we are either reaffirming, or improving, existing guidance today.

Turning first to an overview of our financial performance on slide 2. At the Group level, our underlying profit has increased substantially, due to two reasons: first, the further cost reductions we've achieved as a result of our Simplification programme, and second, the de-risking of the balance sheet which has produced a 40 per cent decline in impairments. Both are above our plans set at the beginning of the year.

While income has declined by 14 per cent in the first nine months, it decreased significantly less, by 7 per cent in Q3 alone, and our third quarter banking NIM was stable at 1.93 per cent compared to the first half.

I am of course, as I just said, disappointed to report a statutory loss for the period driven mainly by legacy issues, especially a further increase of £1 billion in our provision for PPI.

The core business delivered a robust performance however, with cost and impairment reductions offsetting a subdued income line. Returns are significantly above our cost of equity with the return on risk weighted assets improving to 2.6 per cent so far this year.

Further progress on balance sheet strengthening is very clear to see on slide 3.

We have continued to see strong deposit growth, maintaining an above market 6 per cent growth rate year on year. This together with the £31 billion non-core reduction so far in 2012, already above our improved guidance for the year as a whole given at the half year, has helped bring the Group's loan to deposit ratio down to 124 per cent and the core loan to deposit ratio to 102 per cent. This is now very close to our long-term target of 100 per cent for the core, which we continue to expect to reach in Q1 next year, at the same time as achieving a 120 per cent ratio for the Group.

As you will hear from George, our work to transform the Group's funding structure is substantially complete. In addition, capital levels continue to grow, with the Group ending the third quarter with a robust core tier 1 capital ratio of 11.5 per cent, 20 basis points above June's ratio, in spite of the charges for legacy items.

As you know, there has been much comment on UK bank's capital levels in recent weeks. Let me be clear on my view.

We are well placed with a robust core tier 1 capital ratio prudently above our regulatory requirements. Our estimated fully loaded ratio of 7.7 per cent as at the end of September is also well in line to prudently meet our future regulatory requirements, and George will take you through the conservative premises we used in calculating this ratio.

We also have a significantly de-risked balance sheet, both in terms of non-core asset reductions and funding and liquidity, and are therefore in a strong position to lend and support the UK economy, while maintaining strong capital ratios.

And our existing capital guidance already incorporates any additional nominal capital requirements which have recently been discussed industry-wide.

For these reasons, I am very comfortable with our capital position.

Moreover and as previously announced, we continue to explore with our regulators the advantage of becoming a ring-fenced bank ahead of regulatory requirements, which should give us a relative competitive advantage in relation to capital in the future, given our "lower risk" business model.

Turning now to supporting our customers and the UK economy on slide 4. We have made substantial progress in delivering against our commitments to our UK customers.

So far this year, we have helped around 40,000 customers buy their first home. This represents 1 out of 4 first time buyers in the UK.

On SMEs, we have continued to grow our lending by 4 per cent net, broadly equivalent to 10 per cent above a market that contracted by 6 per cent excluding ourselves. We have also committed to lend £1 billion to UK manufacturing and have already exceeded our target of supporting 300,000 start-up businesses by the end of 2012.

The Group was also the first bank to use the Government's Funding for Lending scheme from which we have already drawn £1 billion. This has given us the opportunity to increase our SME charter commitment by £1 billion to £13 billion of gross lending in 2012, as we said at the half year.

And we are also aiming to further support First Time Buyers through using the FLS scheme to offer these customers mortgages at lower rates than would have otherwise been possible.

As you can see, we are fully committed to helping Britain prosper. Being the biggest retail and commercial bank in the UK, our future and that of the UK economy are inextricably linked, as I have said now many times. Therefore helping Britain to prosper is the best thing we can do for Lloyds' shareholders.

Moving to slide 5

I would like to briefly share with you some examples of how we are investing in our core business to build growth and sustainable returns for the future.

We are investing in our distribution capabilities, including in Retail where we have seen internet customers increase by more than one million in the last year, and mobile customers by nearly three million. We have continued to refurbish our Lloyds TSB branded branches and extend their opening hours to better meet customers' needs, as we have already done in Halifax.

And in Wholesale, we have seen the number of customers using the Arena online portal grow by 20 per cent in just the last quarter alone.

Among the many initiatives to improve products and services, our core franchise is being further strengthened by investments to make account switching easier in Retail. In insurance we are helping companies meet their Pensions Reform obligations, and we have invested in ways of assisting referrals into Wealth.

We are also already seeing the benefits from our investments, from the evolution of complaints which have fallen 42 per cent in the past two years and from customer Net Promoter Scores which have been rising markedly across all brands.

We are therefore, quarter after quarter, providing simple, additional value for money and transparent products and services that customers want, helping us build strong customer loyalty and a lasting competitive advantage. This will ultimately strengthen returns for our shareholders.

I will now hand over to George who will talk us through the results in greater detail. George

George Culmer – Group Finance Director

Thank you António and good morning everyone.

As you've just heard and can see on slide 6, we delivered an improved underlying performance in the first nine months, with underlying profit up 148 per cent to £1.9 billion for the Group, and broadly flat year-on-year at £4.7 billion for the core business.

Management profit for the Group was up 29 per cent to £2.2 billion. This was after a number of broadly offsetting items, mostly reflecting accounting and timing differences and the active management of our balance sheet, funding and liquidity positions.

With the prevailing low interest rates and reduction in wholesale funding spreads, we have continued to reduce and shorten the maturity of our gilt portfolio, we have also been active in liability management and we've seen an increase in the mark to market of our own debt; all of which have impacted management profit.

'Other volatile items' of £618 million is mostly the timing, accounting and economic mismatches as we hedge out the Group's interest rate and FX exposures. And the Fair Value unwind of £212 million is well down on last year, due to the decrease in impairment charge.

Looking now at the drivers of underlying profit. Underlying income in the third quarter of £4.6 billion was slightly ahead of Q2, with core income increasing by 2 per cent and more than offsetting the reduction in non-core, which now makes up only 6 per cent of total income, down from 11 per cent at the same point last year.

The core net interest margin for Q3 was again stable at 2.32 per cent, with asset repricing offsetting increased deposit spread, while the non-core margin was slightly down at 0.49 per cent. The decreasing proportion of non-core assets resulted in an overall Group margin for this quarter of 1.93 per cent, slightly above Q2's 1.91 per cent, and in line with our full year guidance.

Looking briefly at costs and impairments. As stated in slide 8, we have delivered a reduction of 5 per cent in total costs in the first nine months, while investing in our core business. This has been primarily driven by our Simplification Programme where run rate savings have now reached £660 million, an increase of £148 million since the half year.

For the full year we expect total costs to be close to £10 billion, representing a reduction of around £1 billion since 2010, and close to the initial plan set at the strategic review, two years ahead of the original plan.

In terms of impairments, in Q3 we have seen a continuation of the trends we saw at the half year, with our prudent risk appetite and strong management controls continuing to drive improved portfolio and asset quality. Impairments of £4.4 billion are down 40 per cent year on year, and we have got continuing good experience in our core retail secured and unsecured book.

For the full year we now expect an impairment charge of approximately £6 billion, around £1.2 billion lower than our expectations at the beginning of the year.

If we now look at the movement from the management profit to the statutory loss on slide 9. Simplification and Verde costs totalled £731 million in the first nine months, with Simplification comprising £332 million of this and Verde costs £399 million.

On PPI, as you have heard, we saw a decline in the volume of complaints received during the third quarter. However, it remained above the level which we anticipated at the time of our half-year results and as consequence it is appropriate to increase the provision for expected PPI costs by £1 billion. This increases the expected cost of contact and redress, including administration expenses, to £5.3 billion, which is our best estimate given current complaint volumes and revised forecasts. Redress payments and costs incurred to the end of September amounted to £3.7 billion.

We have also prudently allowed for a further £150 million in relation to the legacy German insurance business given potential individual claims trends in the German courts.

Adjusting management profit for these statutory items the Group delivered a statutory loss before tax of £583 million, and a tax charge of £419 million, which is impacted by changes in UK corporate and insurance tax rules.

Moving on to the balance sheet on slide 10. Again, as you have already heard, in the third quarter we have taken further action to manage and strengthen the balance sheet.

Strong deposit growth and the reduction in non-core assets have helped us drive a £65 billion reduction in wholesale funding in the first nine months, £52 billion of which was in short term wholesale funding. Maturities of less than one year are now only 33 per cent of our wholesale funding compared with 45 per cent at the start of the year, and 50 per cent in 2010.

And less than one year money market funding now accounts for only 19 per cent of total wholesale funding, and 7 per cent of total funding, including deposits.

We have also maintained a strong and prudent liquidity buffer with total liquidity at the end of September of £211 billion, exceeding total wholesale funding, and being more than three times our short term funding. Our primary liquidity of £95 billion now represents more than 2.6 times our short term money market funding.

And given our strong liquidity position, in recent months we have repurchased more than £10 billion of our senior debt, as part of managing our overall wholesale funding profile and optimising future interest expense.

Looking next at the non-core book. As you can see on slide 11, we delivered a further reduction in non-core assets of £8 billion in the third quarter, with the year to date reduction now amounting to £31 billion, £27 billion of which comes from non-retail assets, which are down by approximately 30 per cent so far this year.

The year to date reduction of 22 per cent of total non-core assets to £110 billion continues to track the fall in RWAs, which are also down 22 per cent to £85 billion. We are now expecting to reduce non-core assets by around £38 billion this year, £13 billion ahead of the original plan and maintaining the strong rate of reduction seen in 2011. And we expect to achieve this while being capital accretive and delivering lower impairments than our original guidance.

Moving on to capital, on slide 12. We continue to maintain a strong capital position. Since the beginning of the year our core tier 1 capital ratio has increased by 70 basis points to 11.5 per cent. This increase was principally driven by the reduction in risk-weighted assets of 8 per cent, with management profits partially offset by statutory and other items. The fully loaded Basel 3 core tier 1 capital ratio increased to an estimated 7.7 per cent at the end of September, while the total capital ratio was 16.6 per cent.

Going forward we will continue with our strategy to maximize capital generation, while the successful resolution of open items such as the treatment of insurance and its capital structure, recognition of defaults, CVAs and SMEs could represent significant upside potential to our pro forma fully loaded numbers.

I remain very comfortable with our capital position and outlook, and I am confident of meeting our guidance to be both prudently in excess of transitional requirements, and of course to comply fully with CRD4 and other future regulatory requirements.

That completes my review of the financials and I would now like to hand back to António.

Summary
António Horta-Osório

Thank you George. So in summary. The Group's underlying performance has been improving in an environment which continues to be challenging.

The core business is also becoming more stable while maintaining returns that are significantly above the Group's cost of equity.

We have made good progress on strengthening the balance sheet with, again, greater non-core run-off than we expected both at the beginning and middle of the year, and continued strong above market growth in deposits, with our funding repositioning now substantially complete.

So, overall, we believe we have continued to deliver on what we said we would, and a bit more. This progress has allowed us to reaffirm existing guidance, and improve it in several key areas.

Firstly, our NIM is expected to be in line with guidance at around 1.93 per cent for 2012.

We now expect total costs in 2012 to be close to £10 billion, a reduction of around £1 billion since 2010 and above our expectations at this point in time.

On impairments, economic conditions and prudent management of our book has allowed us to improve our 2012 guidance to around £6 billion.

We now expect a greater reduction in the non-core portfolio of around £38 billion for 2012, around £13 billion more than we anticipated at the beginning of the year, and done in a capital accretive way as committed.

We continue to expect to reach our long term core loan-to-deposit ratio of 100 per cent in Q1 2013, and to achieve a 120 per cent ratio for the Group as a whole at the same time, both approximately two years ahead of the target set at the strategic review last year

Finally, with respect to our medium-term financial targets, we remain confident of meeting, over time, those that have not already been achieved.

Thank you, this concludes our presentation, and I would now like to open the line to questions.

Question and Answer Session

Question 1: Tom Rayner, Exane, BNP Paribas

Yes good morning everybody. I would just like to ask a question on deposit growth, because obviously still continuing at quite a decent pace and you are going to be getting pretty close to your target levels in terms of loan to deposit ratio both at core and for the Group. And I am just wondering what we should really expect to see once you have reached those metrics? I mean are we going to see deposit growth slow might we see loan growth pick up? Or will we see possibly the loan to deposit ratio dropping below 100 per cent in core, maybe below 120 per cent at Group? And the reason I am really asking is I am trying to get a sense of what the margin implications might be of those different potential outcomes.

Answer: António Horta-Osório

Good morning, that is a very valid question which we have debated long enough as we are now doing our budgets for next year, reviewing our three year plan. So what we think we will do is the following: We want as usually to meet what we have said we would. And therefore you can expect similar behaviour in terms of us achieving the target of 100 per cent by March which will be at the same time as I said, and 120 per cent per cent at Group level. And from then on once the targets are achieved as you were asking, we think we will probably grow savings at a lower rate in line with the markets, because, as you say, we don't need the money, we are generating more than £20 billion of extra liquidity every quarter, year to date more than £60 billion. And we do believe that by then also assuming, as you ask, that our core loan book should start to increase by the middle of next year as I said at the last Results Presentation. We should increase our deposits as a whole at around the market level. So slow it down to market level given all the economic assumptions.

Further question

And the sort of margin implications possibly of being able to slow that growth in deposits?

Answer: António Horta-Osório

Well you have seen recently, as a result I believe of the liquidity rules that have been changed in July, and also I think from the expectations of the Funding for Lending Scheme and I say expectations, because as you know the drawings from the Funding for Lending Scheme have been very small up to date just because as normal it takes three months between a loan being approved and the actual disbursement of the loans. So I think the FLS impact in the market at the moment is just a matter of expectations. The real impact has been in my opinion from the significant change in liquidity rules which we have mentioned several times before and we thought was exactly the right thing to do. Therefore as you have seen, deposit prices according to what has happened, deposit prices have been coming accordingly down. Deposit prices are on a downward trend and I think that trend will continue in the foreseeable future given that the liquidity rules are still being executed in terms of the banks increasing the liquidity buffers and the Funding for Lending scheme will become a reality as the approved loans will be drawn over the next few months.

Further question

Thanks very much. Could I just have one very quick one, sorry, I didn't advertise a second one. But did I hear you correctly you mention the non-core run off as being capital accretive? Is that a slight change in language? I know the constraint has been previously as fast as possible within capital neutral. Capital accretive might sound like a slight increase in confidence over how that is going. Is that fair?

Answer: António Horta-Osório

Well we have always said, if you remember the Strategic Review, we have always said we would do the reductions from 12-14 in a capital accretive way. Then we actually did 2011 reductions in a capital accretive way as well. And when I think this is more from a conversation you and I had in one of the meetings we have, where I told you that if I had to arbitrate I would go as quickly as possible so that it could potentially become close to zero. It is a fact that we have been going much faster than we thought. Still in a capital accretive way, and also with lower impairment guidance which I really think is quite robust and high quality results from all our teams. And we will continue doing so. I will continue to go as quickly as possible in a capital accretive way and within the impairment guidance we have just given to you.

Tom Rayner

Lovely, thanks very much.

<u>Question 2: Claire Caine, RBC</u>

Hi, good morning. I just have a couple of questions please. The first is on your liquidity management. You seem to have recorded another quarter of strong gains, I think around £650 million on sales of your Government bonds. And I was just wondering if you could tell us how much more we could expect to come through from this and give us maybe an update on your unrealised gains in the AFS reserve which I think were about £1.3 billion at the end of June?

And then my second question really is on capital. I was wondering if you would be able to give us a bit more colour on the potential upside regarding your conservative assumptions relating to the reductions and whether there is any change in your view relating to the focus on absolute capital levels versus RWAs? And if you could give us any colour on what that absolute target is going forward through to 2013? Thank you.

Answer: George Culmer

Hi Claire, it is George here. I will kick off answering your question, a few questions there. I mean first up, I will deal with them in reverse order. So the capital position, my first comment, I have been in the business now for about 4-5 months. I first came in May and I said I thought, I was very comfortable with the capital position of the company and the prospects of the company. And I am very comfortable repeating that today after everything that has happened in the summer in terms of press comment and speculation. I remain very comfortable with the capital position of the business.

In terms of some of the specifics. In terms of when we look at things like our fully loaded Basel 3, as you said gone from 7.1 to 7.7 in the first nine months of the year and that is after things like the PPI etc that we have taken there. Within that we do we think show that on a pretty prudent basis. So within that for example, we do show the insurance on a, Article 45 as opposed to an Article 46 and switching from one to other would give you round about just over a percentage point of improvement in our ratio. We take full allowance for example for things like CVAs and if there was a carve out for CVA corporate that would give us another 20 basis points on that. We also assume that we get 90 days default for example on mortgages if it went to 180, that would give us a further 20 basis points on that. And proposed, if there was this proposed 25 discount on SME, RWAs that would be another 10 basis points. So when we show the fully loaded externally, we use a very what we believe is a prudent and appropriate way of actually presenting that ratio. And as we said, there are a number of things where there is upside and in a number of those matters we are very active in terms of lobbying and hoping to secure on. So we continue to be capital generative. We continue to throw off 20-30 basis points of capital from our management actions. We continue to benefit from the reduction of risk weighted assets and we have managed to drive those capital ratios forward whilst at the same time putting aside significant sums for PPI. So I think it shows the effectiveness of our strategy and the list that I went through hopefully also outlines to you the appropriate way with which we present that ratio.

To some of your other questions. In terms of things like liquidity management and as such, yes in terms of again, as I said in the low interest rate environment, we have taken advantage to look at our funding, our liquidity, our balance sheet position. Yes we have now realised gains of about £1.3 billion over the year. That is quite deliberately in terms of coming short. We see no benefit in holding some of those longer duration instruments with what the real economic yields are. So we have taken advantage actually of coming out of those instruments and coming shorter and more liquid in the current environment and the current interest rate environment. And we think that is entirely appropriate. I am not going to give you a forecast for the fourth quarter in terms of precise amounts. But given where interest rates remain to be, I would expect us to continue to be active, but I am afraid I won't give you a precise amount. And in terms of available reserves on the balance sheet, there is still a significant amount, I think of the order of about £3 billion or so, so there are still significant funds there.

Claire Caine
Thank you very much, that was really clear.

<u>Question 3: Michael Helsby, Merrill Lynch</u>
Thank you, morning everyone. I have got three questions if I can. Firstly thank you on the cost guidance, £10 billion for this year. It still feels like you have got quite a lot of simplification benefits to come through. I have actually got £10 billion for next year. So I was wondering if you could just give us a comment on. Have you got big investment plans for next year to offset the simplification benefits? So if you could give us some colour on that, that would be fantastic.

I think you mentioned Antonio, the improvements that you can still see coming through in core ROE because of all the things you set out at the strategy review. I think at the heart of that was this £2 billion of incremental OII. I know RDR is just around the corner, so I was wondering if you could give us an update on that other income improvement because clearly that is something that we just see no signs of just yet?

And finally on bad debt, I note that your £6 billion guidance is clearly a lot lower than what it was and we appreciate that, but it does imply a pick up in the fourth quarter. To be picky I was wondering is there anything specific that you can see or anything in the forward looking credit indicators that you can see to suggest that? Or are you just being prudent because that is your style?

Answer: António Horta-Osório
You are being a bit picky Michael. It is a very boring retail and commercial bank business, but not absolutely like a clock? It is done in the same line and I will ask Juan to tell you about the bad debt and forecast and guidance for the first quarter. And the trends and the colour we will give you all of that.

Answer: Juan Colombas

On impairment performance, you can see it is going really well. So the cost of credit we are seeing this year is around 40 basis points and in the core book and it is picking up the core book. And compared with a 66 basis points last year, it is true that it is implied Q4 growth in total impairments, but we are not seeing any guidance telling us that things are getting worse. The opposite, I would say that the leading indicators we have in our portfolios are showing that the positive trends that we have seen in the past are still there. So it is I would take it as we said in Q1, there is between quarters, some seasonality in the way of accounting for the provisions but I wouldn't say that there is any change in trend whatsoever.

Answer: António Horta-Osório

The other two questions Michael, in terms of the cost diverse, as we have just said, we will be close to £10 billion this year. We have at the beginning of the year improved our guidance from the £10 billion for '14 to 9.8 and as we just said, we are a bit ahead of our plans. So I think you should have that message first effect as a consequence that our nominal costs will go down again next year, that is what I would say.

In terms of core return on equity. Correct what you said, keeps improving and we keep investing for the future because we are investing around a third of the cost savings as we committed and said last year, initiatives for the future, It is also true as we said as well last year, that we would invest as we see the visibility of the cost savings. And depending on the economic outlook, because given that we would be driving the car in the sense that we would first generate the cost savings and then we would invest, we are doing the investment a bit slower than we had planned a year ago because the economic environment has significantly worsened. And we think that is the right thing to do for our shareholders. And what we have committed was that our way would reach in the future around 50 per cent of total income which we still think it will meet because we said a year ago, given the significant worsening in economic conditions that happened in the third quarter of last year, we said we would meet these objectives over time. And we still believe they will be met over time. But given the GDP is much worse Michael, it is normal that we model the investment in our growth initiatives according to that and we do a better trade off which I absolutely think as I just said, is the right thing to do for our shareholders.

The RDR implications in terms of your last question of what was recently announced are not very material for us. It means basically that it is not economically worse for us to offer a £100,000 advice for customers holding less than £100,000. It is not worth it for us to offer advice. We will do indication only which we are absolutely prepared to do in terms of the investments in our platform execution only that we were doing. And that the impact of these small changes is not material for us basically.

Michael Helsby

Okay thank you. Thanks for that.

<u>Question 4: Chris Manners, Morgan Stanley</u>

Good morning everyone. I had just a couple of questions for you if I may. The first one was on risk weightings. I know that FBC has come out saying that they are looking at potentially introducing a dual reporting of risk weighted assets with standardised risk weighted assets as well as model risk weighted assets being disposed by banks. Also I know Andy Haldane has been talking about putting floors on certain asset categories. So I just thought I would ask what you think about the chances of increasing risk weightings on any of your asset classes, particularly on the UK mortgage size would be driven by regulation?

The second one was just maybe if you could provide a bit of colour on the net interest margins into 2013? Should we expect that to continue to drift up, because I guess you have got shrinking non-core which is low margin. Obviously as well you have been able to take down your liquid asset buffer indicating that maybe there is a bit more leeway with that. So should we be building in maybe a bit more net interest margin build into next year? And those are the two questions, thank you.

Answer: António Horta-Osório

Okay, good morning. I will answer the first one and George will take the second one. In relation to your first question, I really think that there is a lot of noise over this issue and I really think you should look at the facts. And I think the facts in terms of regulatory environment in the UK are very clear. And when you think, the financial stability, as I have said many times, is a holistic solution of four pillars where you have higher capital requirements, stricter liquidity, stronger supervision and recovery resolution mechanisms of which ring-fencing is a key part. You should think in my opinion that given the UK is much better than Europe now in capital supervision and recovering resolution – ring fencing, liquidity rules should not be also too strict. And therefore as per what happened in July, I think the release of liquidity rules, the relaxing of liquidity rules was absolutely the proper thing to do in terms of financial stability, in terms of a holistic solution for financial stability.

The second very important point that regulators changed together with the Government, was the Funding for Lending Scheme which I think requires a lot of thought, a lot of political will in order to be implemented and I absolutely think as I said in Q2, is the right thing to do for the UK economy. Therefore as a consequence of this, Chris, I think that when you look at those two facts which are really a fact, you can see what direction the UK authorities are taking in terms of financial regulation. And I do not think as a consequence that they will at this point in time do any change in terms of risk weighted assets apart from what is said, which is basically the slotting in CRE, whose impact has been widely discussed. I do think that what they might ask, which I would see as a fair and favourable thing, is for banks to be more transparent in terms of how they calculate their risk weighted assets in order for the industry to be more comparable. And that is the feedback I have been perceiving in my high level discussions with the regulators. But I do not as a consequence being very clear, foresee any change in risk weighted assets for mortgages specifically as you ask. And I absolutely think as per the changes in the Funding for Lending Scheme and the liquidity rules, that the UK authorities are absolutely committed now to two objectives both first financial stability and second supporting lending and the UK economy.

Answer: George Culmer

Hi Chris. On the NIM stuff, you have obviously seen from slide 7 of the Presentation in terms of progress to date and the 193, and how that breaks down between the discreet quarters and the core and non-core. As you see, our expectation is still for the full year to come in round about for the Group round about 193 and that is on a year to date basis rather than discreet looking forward performance, but we would be about 193 for the year to date for 2012. In terms of the look forward after that, I think we have been speaking about, we would expect to see the margins improve as you move through 2013, starting from about Q1 onwards. That is our current expectation. What is driving that? A number of things which we have already alluded to or covered. Part as you say is the proportions between the core and the non-core and again you have seen the core being constant at the 232, and the decreasing proportion of the non-core book which will continue to run off and continue to run off in an accelerated, accretive way. That is part of it. Then you have got the overall funding mix of the Group and in terms of the shift to the 120 loan to deposit ratio with the core at 100, which we would expect to hit around Q1. And then within that, again as Antonio was mentioning earlier, the pricing of those funds in terms of easing the pressure on the deposits and the improvement we have seen in our wholesale funds as well. So we should get a benefit come through from that. Variables around that, would be things like I mean, in answer to one of the earlier questions, yes we have been coming out of some of the long dated gilts because we think that is the right thing to do. That has a slight drag going the other way. We have been deploying funds to obviously buy back the wholesale funding which is a contra to that. So those are sort of variables that sit around that. But we would expect it to start, the margin to increase predominantly driven by the sort of fundamental change in the balance sheet structure of the business.

Further question

Okay fantastic. So maybe a few basis points a quarter or something, but nothing really sharp?

Answer : George Culmer

I will leave you to decide on that!

Chris Manners
Thank you very much.

<u>Question 5: Jason Napier, Deutsche Bank</u>
Good morning. Two questions please. The first. I notice in the disclosures around non-core run off you make the comment that you think full year capital accretion from non-core will be at a lower level than that of the first nine months. I just wonder whether you could say whether that is just caution or whether there are deals that have closed in the first month of the quarter that make that fact? And whether you would be comfortable saying that you thought 2013 would also be executed on a capital neutral or capital accretive basis?

And then secondly, the disclosures around NPL ratios and so on are sort of absent from this quarter. And we always appreciate sort of balance of quantity versus quality on disclosures but I just wonder whether you could give us the number, the proportion of loans that were impaired at the end of the quarter as well as the pound figure just so we can track the roll off of impaired assets for the Group? Thank you.

Answer: António Horta-Osório
Sure Jason. George will address the first one and Juan will address the second one.

Answer: George Culmer
Hi Jason, it's George. Yeah I suppose to answer your question, part caution, part fact would be the answer to that. We, you know we will be accretive with regards to those disposals over the duration of the year. Obviously as you might expect, you know there is a multitude of transactions that span those twelve months and the commitment is that in aggregate we will be accretive which might change from deal to deal and from day to day. So you know I would expect us to come back slightly from where we sit in terms of the net accretion at the nine months stage, but please, please, please don't read anything into that in terms of trends, do ability, all those sorts of things. It is just in terms of actually how those deals come along. And I suppose to reinforce that, our expectation will be that our commitment will be that in terms of the non-core run down for 2013, yes that will continue to be accretive Jason.

Answer: Juan Colombas
On impairment levels, you can see in the IMS that we have disclosed a coverage ratio for the non-core book that is going up by 4 points since the beginning of the year. The total impairment loans of the Group are coming down as a consequence of the cleaning of the balance sheet in the non-core book. And in retail I would say that we are having flattened impaired assets. The good news is that more complicated portfolios that, especially lending that we have in the mortgage book as we told you in the previous quarters is flattening as well. So they are performing as we were expecting in a good sense. And so overall in retail I would say it is more of the same. So flattening in mortgages and improving performance in the unsecured books. In the wholesale book as I said, nothing new so also increasing the coverage ratio of the wholesale core book. So that would be my summary.

Further question
So the proportion of Group impaired assets that were non-core was sort of roughly the same number as last quarter and coverage was about a percent lower, so just to sort of be clear, the 9.6 per cent of loans that were impaired at the half is down again in aggregate?

Answer: Juan Colombas
The total of the loans are close to 9 per cent and the provisions are slightly up as a coverage ratio.

Jason Napier
Thank you.

<u>Question 6: Arturo De Frias, Santander</u>

Yeah hi, good morning. I have three quick questions if I may. The first one the kind of long term strategic question is on core returns. Looking at your quarterly numbers in terms of what the return on risk weighted assets has been doing at the core. We have seen after a few quarters in which it looked to be fairly stable in the region of 2.3, 2.4 maybe, 2.5 per cent return on risk weighted assets. We have seen in this Q3 a substantial increase. We have gone to nearly 2.9 per cent on your disclosure which is usually an extremely interesting return of close to 30 per cent. Listening to your write downs in terms of stable margins, increase in volumes, falling costs and falling impairments, one would think that there is only one way for this return on risk weighted assets at the core and that is up going forward. So the question would be, do you think this increase to RORWA at the core in the region of 2.9 per cent is sticky and will remain in that ballpark in coming quarters? That will be the first question.

The second question is, if you can update your position on dividends after all this noise, as you call it, around capital, around RWAs etc, you look increasing comfortable with your RWA trends and with your core tier 1 trends and with the positive impact that we might see from CRD4. So what is the impact of all that on your dividends and well obviously if you could tell us when you expect to start paying dividends, that would be fantastic! And how much per quarter!

And finally, wholesale, there is no information on the divisions within core retail wholesale etc. I remember that in the previous quarters we had seen a clear weakness in wholesale with disappointing returns etc. Could you give us some quick comments on how wholesale is performing? Thank you.

Answer: António Horta-Osório

Okay I will take the first question and George will take the two later questions. So in terms of your first question which is quite comprehensive and very important by the way. I think you are basically right. Our core returns, as I said in my speech are behaving very decently in a difficult economic environment, both from a GDP perspective and from an interest rate perspective. And the way I see it going forward is, impairments have substantially come down. We are around 40 basis points in the core book which is within the guidance we gave you on a long-term view for '14, where we said 50-60, the core being on the lower end of the range. So we are inside the guidance which means we have a higher quality loan book than we thought 15 months ago, given all the work that has been done. And we think it will be around that number. So we are foreseeing if you want, stable as a percentage, AQR going forward, costs will continue to come down and eventually stabilise. But revenues as you said, which are coming down, although they are being more than offset by costs and impairments and therefore the return as the revenues have been increasing, the revenues will start flattening as you see in the quarter. NIM will start to increase as George said in our view from Q1 onwards, the Group NIM will start to increase. And I believe that the core book will start to increase as I said in July, around June, because we will have finished our repositioning of the mortgage market share and we are having the impact of good growth in net lending for SMEs. Mid corps should start going up by January as I said. In July large corporates will start to increase again given that we no longer have the costs of funding disadvantage with the FLS scheme. So revenues will eventually start to increase probably after the core book starts to increase in June next year. And therefore when you combine all of these so you have positive jaws going forward, and stable RWAs or slightly increasing as the core book increases, I do believe that the core returns will increase over time. I think you are absolutely right about that. George.

Answer: George Culmer

On the dividends, obviously this is going to be ultimately a frustrating answer for you, but I mean as we, you know as we have said before, I mean there are a number of pieces that need to fall into place. We have had the ICP paper. We are still waiting for the CRD4 and the detail on the CRD4 which obviously is now being pushed into next year. It doesn't mean we are waiting and doing nothing. I mean the, going back to an earlier answer, the strategy we pursue is the capital generative strategy. You know we add through managing profits 20-30 basis points per quarter to the capital ratio. We add to the ratio through the deleveraging of the balance sheet. Yes those have been mitigated by some of the one offs, the PPIs etc over the last few quarters, but the strategy we pursue is the right one. And what we await is clarity on the calibration and we will be able to respond I think more specifically after that.

Further answer: António Horta-Osório

And just to be very clear, we really think the noise that you saw in the press. We have as we told you in July, we have spoken to our regulators and told them we would like to have this discussion as soon as we have visibility on the CRD4 details which as George said may have significant upside impact on what we are assuming at the moment. And they said yes. So we will have that discussion with the regulator when the CRD4 paper is out and we will then have the path to dividends which we will share with you. Unfortunately and this is totally out of our control, this paper is being consequently has been repeatedly delayed which is a bit annoying. But we are as George is saying, following a capital maximisation strategy which is generating significant capital, so we are as I have said many times going absolutely in the right direction. We have to see the intensity with the CRD4 paper details and we will then have a discussion with our regulators in terms of the light we pass to dividends.

Further answer: George Culmer

In Wholesale you are right, in Q2 you remember Wholesale had a weak second quarter, mainly following market activities and low levels of activity and it was well down. What I can say, you are right, we don't disclose divisional information, but in Q3 Wholesale has come back good forms of rates, good DCM positions and you have seen a very material pick up in Wholesale's performance, if I look at Q3 2012 versus Q2 2012. So it is a very significant pick-up.

Arturo De Frias

Okay thank you very much.

<u>Question 7: Manus Costello, Autonomous</u>

Good morning. I had a couple of questions on the NIM, one near term, one longer term. In the near term, I wondered if you could give us some colour on what moves the NIM in 3Q versus 2Q, particularly how much benefit you gained from the change in the base LIBOR spread and the SVR repricing which had a full quarter? If you could break down how that moves, that would be helpful.

And then on the longer term NIM, you talked about the benefits the FLS could have on the deposit pricing side of the equation, I wondered if you had any thoughts on what might happen to asset repricing with the FLS? Because when you were talking about the variables George, you did not mention asset prices as a variable for NIM next year.

Answer: George Culmer

Hi Manus, it's George here. I mean the short term, for example, yeah on the short term on NIM, if I look at the nine months, if I start there, I think some asset pricing has been offset by deposit pricing. If I look through the nine months. If I look though at in terms of Q3 in isolation, asset pricing was about double that actually of deposit spread and mix. So we actually saw asset pricing pull ahead.

Further question

And that was SVR driven basically?

Answer: George Culmer

In the third quarter. SVR has been part of that. Remember SVR was May so that has been flowing through that so we saw as I say in Q2 a bit of asset pricing pull ahead.

Answer: António Horta-Osório

And relating to the FLS comment Manus, what I think is the following, I think that Funding for Lending should be as the name indicates funding for lending. And that is what we are doing, so we are estimating that we will have around 100 basis points advantage in the Funding for Lending costs which we are passing through to customers and we are using our previous governance and controls of the NLGS scheme which was by coincidence exactly 100 basis points passed through to customers, we are using the same scheme, but more broadly because we now use the FLS for all customers in SMEs and mid corps, so without exceptions which is much broader than LGS. Therefore I do not think that in itself it has a big impact on our margins. It will have an impact on volumes as is our intention. And therefore in terms of asset prices, you can expect in our case that our prices to customers are having that pass through of 100 basis points which I think is broadly margin neutral.

As I said at the beginning of this call, I think that both the expectations of the FLS scheme and the big changes to the liquidity rules are correctly bringing deposit pricing down which has a positive impact on our margins both from a deposits pricing perspective and also from the possibility of moving this huge amount of liquid assets we have in gilts as we serve and in central bank deposits into buybacks of our debt when we have an average pick-up of around 150-200 basis points.

Further question

You think the FLS will therefore only bring down prices for the marginal lending which is FLS funded, it won't have any impact on other lending in the economy which is not necessarily directly FLS funded?

Answer: António Horta-Osório

No I mean I don't think you can see this that way because it is not on the marginal lending. It is on the gross lending which is the new lending. Because the net lending is the objective of the scheme. But for you to pass through the 100 basis points to customers you have to do it in all gross new lending and that is why as also Paul Fisher from the Bank of England said, he expects the draw downs of the FLS to be significantly higher, that the net lending increase to the economy, because for you to pass through the price benefits, you have to do it in gross lending. And given that customers repay loans as you know, the net lending impact is much smaller so I do expect at least in our case, all gross new lending to SMEs and to mid corps, to follow the Funding for Lending Scheme or the mortgage market which is a different story. What we have then is to allocate £500 million to a new seven year fixed rate mortgage to first time buyers because we do think that it is the best option for clients at the moment given the very low level of interest rates is to lock out rates for longer and that is why we have made the seven year first time buyer mortgage fixed rate, much cheaper than what we had before, and also much cheaper than what we have for the five year one.

Manus Costello

Okay, thank you.

Closing remarks

I think at that stage we will conclude the call actually as we are slightly over our time. So thank you very much everyone. If there are further questions please do come through to the Investor Relations Team.

António Horta-Osório

Okay, thank you very much everyone and again thanks for joining us.

End of Q&A