LLOYDS BANKING GROUP PLC – 2014 Q3 INTERIM MANAGEMENT STATEMENT

TUESDAY 28 OCTOBER 2014

Lord Blackwell, Chairman

Good morning everyone. For those of you who I haven't met, I am Norman Blackwell, Chairman of Lloyds Banking Group since April this year.

On behalf of the Board and the Executive Team I would like to welcome you to the presentation of our results for the nine months ended 30 September 2014 and of our Strategic Update.

I am introducing this session this morning because, as well as our results, in a moment our Chief Executive, António Horta-Osório and members of his executive team will present the key strategic priorities for the Group for the next three years.

Before that, however, I would like to hand over to George Culmer, our Chief Financial Officer who will run through the key financial and operational highlights from our third quarter results, which were issued to the market this morning. After he has given you this overview, there will be an opportunity to ask a few questions on the results before we move on to the Strategic Update, which is the main focus of this morning's presentation. So thank you.

George over to you.

George Culmer, Chief Financial Officer

Thank you Norman. Good morning everyone and thanks for coming. As Norman said, I will cover the Q3 IMS and if it is okay, I intend to move pretty rapidly and then we can get onto the strategic update. So in 2014 we have continued to make strong progress, with improved profitability, increased lending and deposits in key customer segments, and we have continued to strengthen and reshape the balance sheet. And this reshaping is now substantially complete. The run-off portfolio was £23 billion in September, and we remain firmly on track to achieve our improved guidance of less than £20 billion by the year end. In addition, in September, as you know, we successfully disposed of a further 11.5 per cent of TSB, taking our remaining shareholding to 50 per cent.

On financial strength, we've seen a further significant strengthening of our core tier one and leverage ratios. And we've also seen excellent progress on financial performance with strong improvements in both our underlying and statutory profit after tax.

Finally, you will have seen this weekend's announcement that we passed the EBA stress tests. As you know, the EBA stress test was especially punitive as regards the UK residential and corporate real estate market.

As you would expect we adopted a thorough and conservative approach to our modelling and were pleased that the tests highlighted the strongly capital generative nature of our business, which will obviously continue to benefit us as we move forward.

As you know, the PRA stress tests are published on the 16th December. These tests are even more targeted at UK residential and corporate exposures, but also contain some significant modelling differences to the EBA.

And with the strength of our balance sheet and capital position, I expect to pass the PRA tests.

Looking at the financials then in more detail. Income excluding SJP was up 3 per cent to £13.9 billion. This was led by net interest income, which was up 11 per cent, off-set by the expected lower levels of OOI. The increase in net interest income reflected an improved net interest margin of 2.44 per cent and growth in our key customer segments.

Underlying profit was £6.0 billion up 35 per cent driven by the growth in income, as well as an underlying 6 per cent reduction in costs and a 59 per cent reduction in impairments.

Statutory profit after tax was £1.4 billion representing a five-fold increase on last year, with the improved profitability and lower tax charge more than offsetting the additional charge we have taken in the quarter for PPI.

This increase in profitability was also a key driver in the improved return on Risk Weighted Assets, which was up over 1 per cent to 3.05 per cent, the increase in the core tier one ratio to 12 per cent, the increase in the leverage ratio to 4.7 per cent and the improvement in TNAV to 51.8p.

Looking briefly at loan and deposit growth. For loans, the trends we reported at the half year have continued into Q3. We have grown our net lending in mortgages by 2 per cent, and continued to make strong progress in SMEs, which is up 5 per cent, and grown share in the contracting mid-sized market.

Our Consumer Finance business has continued to accelerate strongly, with UK lending increasing by 15 per cent year on year, driven by strong growth in Motor Finance.

And at the overall Group level, after excluding run-off and other closed books, we have grown our year on year net lending by 3 per cent which is clear evidence of our determination to support our customers and the UK economy.

On deposits, we have continued to focus on our relationship brands in retail and our Transactional banking balances in Commercial, whilst managing our other brands more tactically.

Managing this mix has delivered a 3 per cent increase overall and helped to improve our loan to deposit ratio, which stands at 109 per cent, versus 113 per cent at the start of the year.

Turning now to look at some of the P and L lines in more detail. As mentioned, net interest income was up 11 per cent at £8.8 billion. This increase was driven by better deposit pricing, lower wholesale funding costs, and loan growth in key segments, partly offset by expected asset pricing headwinds and run off reductions.

The year to date net interest margin of 2.44 per cent is 38 basis points higher than 2013 and in the third quarter, the margin strengthened to 2.51 per cent, mainly due to continued tailwinds on the liabilities side. And for the full year we expect the margin to be in line with our previous updated guidance of around 2.45 per cent.

OOI remains challenging with the year on year reduction also impacted by the sale of SJP and other disposals. The Q3 total of £1.6 billion was marginally down from £1.7 billion in Q2 due to lower insurance profits and the impact of further reducing the run off portfolio.

On costs, these total £6.9 billion for the year to date, which is 6 per cent lower than 2013 after excluding the timing effects of FSCS.

Our market-leading cost:income ratio now stands at 49.7 per cent. And while Q4 will be impacted by the Bank Levy, we are on track to deliver our targeted full year 2014 cost base, excluding TSB, of around £9 billion.

For impairments, we've seen a 59 per cent reduction in the nine month charge to £1 billion, with the year to date AQR improving significantly to 27 basis points.

Year on year, NPLs are now just 4.5 per cent of assets, down from 6.3 per cent at the start of the year, and over 10 per cent back in 2011. And we expect to show further progress on NPLs by the year end.

On coverage, the coverage ratio has strengthened to 56.6 per cent, a 6.5 percentage point increase since the start of the year and 2.6 points since Q2.

As a result of the better than expected trends, we are revising our full year guidance, and now expect the AQR for the full year to be around 30 basis points, compared with the revised guidance of around 35 basis points that we gave at the half year.

Turning to PPI, we have increased our provision in the quarter by £900 million. Almost three quarters of this increase relates to reactive claims which were 18 per cent down on Q3 last year but marginally up on Q2 and ahead of expectations, with the remaining amount relating to increased remediation and related costs. Since quarter end we have seen a reduction in reactive complaints, but the provision, as ever, remains sensitive to future trends.

In terms of overall cash spend, this continues to run at about £200 million per month. However, as we said at the interims, we'd expect PBR and remediation costs to be substantially complete in the first half of next year.

Ongoing cash spend at that point will predominantly relate to reactive complaints and I would therefore expect a significant reduction in the monthly cash outflow.

In terms of the overall reconciliation from underlying to statutory profit, most of these items are well known to you. They include the charge for the ECN exchange, Simplification and TSB costs, as well as the charge for PPI within legacy costs.

The effective tax rate for the year was 14 per cent reflecting tax-exempt gains on our disposals in the first half, and a low tax rate in Insurance.

And statutory profit after tax is £1.4 billion, and is significantly up on 2013 due to the improved underlying profitability and the lower tax charge. And looking forward, I continue to expect the full year statutory profits to be significantly ahead of the first half.

Finally on capital as you've heard, our fully-loaded common equity tier 1 position increased to 12 per cent from 11.1 per cent at Half 1 driven mostly by underlying profits and the ongoing reduction in risk-weighted assets.

On leverage, we remain in a strong position and have increased our ratio on a Basel III basis to 4.7 percent from 3.8 per cent at the start of the year. This includes a 50 basis point benefit from our AT1 issuance which added to the positive effect of strong underlying profits.

And the continued strengthening of our key capital and leverage ratios remains clear evidence of the successful execution of our low-risk strategy and the capital generative nature of our business.

So in summary, so far in 2014 we have continued to execute successfully on our strategy. We have grown lending and deposits, reduced costs, improved profitability and strengthened the capital and leverage ratio.

This strong performance has enabled us to provide further improved full year guidance on impairments, as well as to confirm our existing guidance for net interest margin and run-off.

And the discussions with the PRA on dividends remain ongoing.

Going forward, I have great confidence in our ability to deliver continued strong and sustainable returns.

That concludes my review. We now have time for one or two questions before moving onto the strategic update.

End of presentation

Question and Answer Session

Question 1: Chintan Joshi, Nomura
Inaudible question due to lack of microphone.

Answer: George Culmer
First up on the margin questions I said the overall margin Q3 was about 2.51 per cent which I think compared to 2.48 per cent in terms of Q2 and as I said in the presentation are familiar ones to you. I have got I think liabilities was I think 5 or 6 basis points benefiting there of about 3 or 4 from the assets. And I have seen that mix pretty consistently as I have actually moved through the period. On the SVR book, particularly on the Halifax one is a shade under about £60 billion, I think it is about £59 billion. We haven't seen any material movements in terms of changes in attrition rates recently. So if you go back 18 months I think that was a shade over £60 billion, about £62-63 billion. As I said it is now about £58-59 billion. But we have not seen any material changes in attrition rate recently and I will get back to you on differences between attrition to that and the C&G book.

Question 2: Tom Rayner, Exane BNP Paribas
Tom Rayner, BNP. Can I have a couple please? Just on the P&L items. Non interest income seems to be the one where I think your last guidance was for stable in the second half. It seems to be a little bit weaker than that. And just I wonder if you have got any more visibility now on whether Q3 is really the sort of run rate for non interest income and then I just have a second question on PPI please.

Answer: George Culmer

Yes okay so the £1.6bn you are right was slightly down on £1.7bn and slightly disappointing. When you look across the divisions there are some interesting things going on. If you look for example at Commercial. Commercial was flat on OOI Q3 versus Q2 which was encouraging, as was Consumer Finance. Retail was marginally down I think about £20 million Q3 on Q2, higher transaction costs, use of other ATMs etc have been the main drivers there. The main one actually in terms of trend was probably insurance. We had some adverse claims experiences compared with the write-back in Q2 and I think the net swing of those affects had about a £40 million impact. We have also been benefiting from the transfer of assets from the Commercial business into the Insurance business and lower level of VAT in Q3. So again I think the Insurance business in aggregate was about £90 billion down Q3 versus Q2.

As I look forward, as I say the 1.6, it would be nice to get to about 1.7 in Q4. I would certainly expect a stronger performance from the Insurance business in Q4 and provided that the other businesses can continue on trends, then I think we have a reasonable chance of getting to that 1.7. The backdrop hasn't changed. Conditions do remain tough etc as we move forward, we would be looking to grow the OOI book, but again I would temper ambitions and expectations in terms of the rate of that growth because of some of those fundamentals around the conduct regime and the backdrop are going to stay present. But as you say, 1.6 slightly down, but let's see how Q4 pans out, but we would hope for about 1.7 provided we can get the hopeful turnaround in Insurance.

Further question

Just on PPI. Obviously looking at unutilised provisions versus currently monthly spend etc, doesn't really help to get us to the right answer on when the PPI charges might stop. Is there an element here which is probably not possible to analyse, but just reflecting things like record keeping. So when claims management companies are trying to push back further and further in time, is it actually just cheaper for the banks to settle rather than even try and dig out records that no longer exist? And following on from that I just wonder whether there is an issue that a moratorium needs to be called at some point. Are you able to comment on your thoughts about that?

Answer:

Okay. There is no specific records issue. I mean obviously within that, the further one goes back in time, the less evidence one has and certainly in terms of any submitted PPI complaint you have got 8 weeks to turn it around. What one has to do is effectively carry out a fact file in terms of the customer's condition at the time and you have to go back in time and actually recreate that. And then you have got to look at the conditions around the sale and make sure that all the disclosures were made. But unlike other stories you might have heard, we have no specific issue around cut-off points in terms of data, in terms of information or anything like that. What we are seeing and the reason for the provision as I said in the Presentation, reactive complaints which were down 18 per cent year-on-year, but they were up in the quarter. And what happens is we factor that into our model in terms of projecting future claims and if I have a period of flat, now I think they are up 2 or 3 per cent, I extrapolate that out and obviously the area under the curve comes back to the amount you are seeing today. And of the £900 million, some £660 million relates to that reactive bit. The good news I suppose, in the three weeks since the quarter end is that claims are down, but I would caution that as it is but three weeks and I think we have given some sensitivities in the RNS that says, were claims to stay at the same Q2 levels that we have seen, sorry the Q3 levels there would be something like a further £600 million that would be required. But we have seen claims reduced of late.

In terms of things like moratorium, it is tough. And at various times various initiatives commence but enabling to get agreements amongst the regulator, the consumer groups and the banks is proving a tough task. The idea is attractive and a certainty appeals, but getting down into the detail and getting to the situation where each party can walk away from the room and declare that they have got what they wanted has so far proved beyond the parties. But going back to your original question, there is no data issue, we continue to deal with complaints. What we are seeing though is reactives have been sticky. No spike up in things like CMCs, it is just CMCs are staying the course. Various fluctuating between 49 and 69 per cent. I think they have averaged about 60 per cent over the last 8 weeks or so. But we just remain subject to what happens on those reactives. Cheers Tom.

<u>Question 3: Sandy Chen, Cenkos Securities</u>

Hi it's Sandy Chen, from Cenkos Securities. I have just one question actually. In the Q3 there was a £900 million pound top up on PPI but it seems like no other top ups on other regulatory fines. Should we interpret that, as particularly looking at the FOREX investigations that you don't expect any further fines related to that?

Answer: George Culmer
That is correct. You are correct in both observations. That there were no other top-ups. And in terms of the FOREX, we weren't in terms of the first tranche of the banks that were looked at that. We went to the FCA and said we should conduct our own investigation which we did. We have taken those findings back to the FCA and our work on that, to all intents and purpose is complete.

Question 4: Rohith Chandra-Rajan
Just a quick question on the revised impairment guidance which implies 40 basis points charge for the fourth quarter from 20bps in the third. You characteristically through the course of this year and I guess the second half of last, have been quite cautious on that. So just trying to square that guidance with your expectation of further falls of NPLs but a big pick up in the charge please?

Answer: George Culmer
Q4 is always the one that takes a good hard look at the book and in terms of our forward guidance, I think there is an element of that as well. But what I would say to you, it does not reflect any change in terms of the overall trends that we are seeing. I think it is more reflective in terms of the internal seasonality of process than one of the sort of external changes in terms of what is going on in the market, but I think it remains a good news story.

Question 5: Jason Napier, Deutsche Bank
Good morning, it's Jason Napier from Deutsche. Two please. The first on the topic of stress tests. It appears that the process that the PRA is taking everyone through would perhaps be a bit more logical from a revenue and cost standpoint. But I wonder whether there is any reason why tougher assumptions on house prices, CRE, interest rates, unemployment, GDP, don't automatically lead to a higher cumulative loss than the 25 billion Euros that was in the weekend disclosures ?

And then secondly, the disclosure or the bridge that you have given on net interest income are quite clearly the repricing of deposits has been very powerful so far. Less use of tactical brands, the mix is improving, LDR is on target. Can you give any sort of sense of where the mark to market deposit costs are relative to back book or the pace of repricing you would expect ? And also whether you are reiterating flat margin over the next 6 to 12 months ? Thank you.

Answer: George Culmer
In terms of the first obviously, yes EBA stress test which I talked to in the speech and obviously you have all seen in terms of our 6.2 per cent in terms of the transitional basis. I also suggested alluding to that we also showed a 6 per cent on a fully loaded basis and obviously the potential of otherwise look forward to the PRA stress tests which as I say we announce on the 16th. Again as you all know and as you articulated, that is more severe on the UK housing market in terms of assumptions, in terms of HPI etc. So all things being equal, the first thing one would presume would be whatever we scored on our EBA, we will go down on PRA which is a sort of first pass and which you would accept. Going the other way though and again as you are probably aware, there are some major modelling methological differences between the EBA and the PRA and we would certainly expect to and in fact we do benefit quite substantially from that change in methodology and examples would be as you know things like the no cure on the mortgages which has a very significant effect. You are up to a couple of billions in terms of impairments. In terms of the removal of cost floors and removal of caps in terms of income. Again they have a very material impact upon our numbers. So on first pass you play in, yes I have got a more severe stress so it is a negative, but then when we see the more realistic PRA scenarios, we would expect to see, well I know we do get significant credits from the modelling of those to our numbers. And as I said in the presentation, and I think as I said in July when we first submitted those numbers, I expect to pass the PRA stress test and that very much remains the case.

In terms of the second question, sorry I won't be goint to be able to regale you with differentials of front book or back book pricing and all those sorts of things. I certainly would expect that as we move forward we will continue to see certain opportunities in terms of liability deposit pricing. And again as I look forward on NIM I would have some structural advantages in terms of as the run-off book decreases, as I factor in the wholesale costs that come through, they should benefit as well. But going back to one of the earlier questions, those asset headwinds are out there and in terms to which they actually factor in the differential between some of those tail winds and headwind, we will see. I won't give specific guidance for next year. We will probably sort of do that at the full year stage. But I think we are in a pretty robust position where our margin is at the moment.

Question 6: Andrew Coombs, Citi

Morning, it is Andy Coombs from Citi. Two questions from me please. Just firstly coming back to the NIM, I won't push you on guidance for next year, but purely looking at your full year guidance for 2014-15, given what you have published in Q3, it would seem to imply small down-tick on Q4, not huge, but ever so slight. Am I reading too much into that? Is it a case of prudent guidance or do you expect you are at a turning point on the NIM trajectory?

Answer: George Culmer

It is not a turning point, it certainly is not a turning point. You may be reading too much into that. You are into the few basis points 251 versus 248 quarter on quarter. You are into the sort of spurious science stuff. Yes we are not signalling that I have reached some inversion point or anything like that. So rest assured.

Further question

And on the loan book, you have seen a further contraction during the quarter, part of that is due to the run-off portfolio, but you also highlight Global Corporates and taking a step back there. You have given guidance on the full year of your expectation for the run-off portfolio, but perhaps you could give us an idea of how much further there is to run on the Global Corporates side?

Answer: George Culmer

I would expect further contraction on the Global Corporates and actually that will be particularly stark because Q4 last year we had a very strong quarter in terms of building that Global Corporates book. So I struggle to remember, but I would expect to see some further contraction, we can give you the number later, but I would expect to see further contraction in Global Corporates particularly on a year to year basis in Q4.

Question 7: Raul Sinha, JP Morgan

Raul Sinha, from JP Morgan. Thank you for taking my question. Sorry to keep you, just focusing back on the run-off portfolio of £23 billion, I didn't find it, so apologies if I missed it. But could you tell us what is the Irish element of that and what the coverage ratio on the Irish element of that is? Have you taken any write-backs in this quarter and how is the trend of write-backs progressed through the year? I think this is something that you have obviously seen in your accounts?

Answer: George Culmer

In terms of the P&L charge, we continue to compare against the Irish portfolio, but there has been about £100 million of write-backs and releases when I look at the nine month data. In terms of the net position, I can tell you the percentage for year because actually the net exposure is down about 25 per cent from the start of the year in terms of the nine month stage. But in terms of the net, I am struggling with what the number is. Do you remember what the net book is?

Further answer: Juan Colombás

The commercial book is 1.7, for Retail it is around 6.

Answer: George Culmer

And it is down 25 per cent year-on-year. Okay with that I will hand back to Norman.

End of Q&A