Lloyds Banking Group plc – Q1 Interim Management Statement 2011

Thursday 5 May 2011

Tim Tookey – Group Finance Director

Good morning everyone and thank you for joining the call.

Before we go into the interim management statement in detail, let me give you some context.

At the year end we said that in the short term, we expected income trends to be affected by continuing customer deleveraging and subdued new lending demand. This together with a further decrease in non-core assets, was likely to result in a continued reduction in the overall size of the Group's balance sheet.

We also said that 2011 would see limited asset repricing opportunities, and these were likely to be offset by elevated wholesale funding costs, while low base rates and competitive markets would keep liability margins depressed.

We also indicated that we expected costs in 2011 to be roughly flat and that we would see further reductions in impairments.

We also reiterated the importance of funding and liquidity in maintaining a strong balance sheet.

It is with this context that we present our Q1 IMS today and so let me start by looking at the highlights.

We have continued to reduce our risk profile, achieving a further £21 billion reduction in non-core assets, which will position us well for the future, enabling us to reduce our funding costs over time.

We have made excellent progress against our funding objectives for the year, with strong customer deposit growth, good wholesale funding issuance and a further accelerated reduction in government and central bank support.

We have also taken, as you have seen, a provision of £3.2 billion for PPI. Despite this provision we have maintained a strong capital position, and in terms of our first quarter performance our core business is performing but recovery is still fragile.

Let's go into more detail, firstly on balance sheet de-risking on slide 4 of your packs.

We are pleased with the substantial progress made on non-core asset reduction. We have made reductions of £126 billion since we started the programme, of which £21 billion was in the first quarter of this year.

The reduction in this quarter includes sales of treasury assets of nearly £11 billion, which resulted in headline losses on disposal of £426 million, but these losses were broadly offset by the related accelerated fair value unwind, indicating that the overall marks we had taken on these assets were correct.

While the treasury asset disposals will result in lower fair value unwind in the future, these transactions have provided significant funding flexibility.

Last year we made excellent progress against our funding objectives, and this has continued in the first quarter of this year, with £13.5 billion of public term issuance.

We have successfully issued across a broad range of products, currencies and markets, including a first Sterling covered bond and a 3.5 year senior unsecured Singapore dollar transaction, as well as issuances out of our new SEC registered shelf.

We are pleased with our funding achievements, particularly given the uncertainties affecting the wholesale markets. Let's not forget that Q1 has seen considerable global worries, including in the Middle East and North Africa, natural disasters in Japan and New Zealand, and recurring European sovereign concerns.

The tenor of our issuance in the first quarter of the year allowed us to broadly maintain our maturity profile of wholesale funding, with 49% of wholesale funding having a maturity date greater than one year.

We have also achieved increases in our customer deposit base.

Total customer deposits excluding repos increased by 2% in the first 3 months, reflecting good growth in relationship deposits in the Retail and Wealth businesses. During the quarter we continued to build our current account and savings franchises, increasing deposit balances, despite these markets being pretty competitive.

Moving on to our loan-to-deposit ratio.

Well the contraction in non-core loans and advances and growth in customer deposits has improved our ratios further, with our overall loan to deposit ratio now at 148%, and this is very good progress.

Slide 8 shows the position on government and central bank funding.

All the progress I just talked you through on term issuance, deposit growth and balance sheet reduction has allowed us to substantially reduce the liquidity support we receive from government and central bank sources, with a £26 billion reduction achieved in the first quarter.

This leaves circa £70 billion of government and central bank funding outstanding, of which £44 billion relates to outstandings under the UK Credit Guarantee Scheme, and we also maintained our primary liquid assets of close to £100 billion.

Before going on to our trading performance for the quarter let me comment on our provision for Payment Protection Insurance, and its impact on the Group.

We have previously disclosed that the financial impact on the Group of the FSA's Policy Statement and the FOS' approach to the handling of PPI complaints could be material and that there was a wide range of potential outcomes.

Two weeks ago, the High Court dismissed the BBA's application for permission to seek judicial review against the FSA and the FOS. Following that judgement we have been in discussions with the FSA to seek clarity around the detailed implementation of their Policy Statement.

I have included a detailed note in the IMS itself, and whilst there are still a number of uncertainties as to the eventual likely total costs, we consider that a provision of £3.2 billion is appropriate.

Clearly this provision has had an impact on our capital position, and on slide 10 we show you that despite the statutory loss, principally arising from the PPI provision, we maintained a strong capital base. Our core tier 1 capital ratio reduced slightly to 10%, with the PPI provision largely mitigated by the 4% reduction in risk weighted assets.

I felt it was important to address balance sheet, PPI, capital and funding up front, but now let's turn to the trading performance of the Group, on slide 11.

In the first quarter, the Group delivered a satisfactory trading performance given the subdued UK economic environment and our risk reduction initiatives.

The first quarter has seen a continuation of the headwinds that I discussed earlier and at the year end.

Total income, net of insurance claims, decreased by 12% compared to Q4.

Underlying income, which excludes the effect of the mark-to-market movements on our ECNs, reduced by 9% quarter on quarter.

However, were you to exclude the losses on the disposal of treasury assets from underlying income, then the decrease in income would be circa 2%, which is broadly in line with a 3% decline in our average interest earning assets since the fourth quarter.

I haven't shown the Q1 on Q1 comparisons here but if you did the analysis, you would see a similar pattern. However, you would need to take into account the absence this year of the benefits from the liability management exercises we saw in our Q1 results last year.

Our net interest margin was 2.07%, moving largely as a result of the costs of increased wholesale funding. Some of the margin headwinds are likely to continue in the remainder of the year.

Operating expenses were broadly flat, as cost savings were partially offset by increased investment, regulatory and other costs. We continue to expect costs for the year as a whole to be broadly flat when compared to 2010.

The integration is still going really well, delivering annualised run-rate cost savings of circa £1.6 billion per annum at the end of the first quarter. We remain on track to achieve our £2 billion of run-rate cost savings by the year end.

The impairment charge in the quarter was £2.6 billion, a reduction of 31% from the charge in Q4 2010.

We delivered a profit before tax on a combined businesses basis of £284 million, and we incurred a statutory loss before tax of £3.5 billion, largely due to the PPI provision.

Let's look at impairments in more detail.

The impairment charge in our portfolio was in line with expectations, with the exception of the Irish portfolio. The charge was approximately £500 million above our initial expectations, and this difference was predominantly due to Ireland.

In Retail, the secured impairment charge continues to be impacted by downward house price movements. This is consistent with our expectation for an increase in this charge in 2011.

The Retail unsecured impairment charge in the quarter decreased, reflecting continued improving portfolio trends resulting from the application of our prudent risk appetite, management actions taken over the last two years, and relatively stable unemployment.

The Wholesale impairment charge has fallen significantly over the last 12 months, reflecting continued robust risk management, stabilising UK and US economic environment in 2010 and of course the benefits of the low interest rate environment.

So in summary.

We are pleased with the significant further progress in reducing the Group's risk profile in the first quarter. We have achieved substantial reductions of non-core assets and have strengthened our funding position, with strong customer deposit growth, strong wholesale funding issuance and a further substantial reduction in government and central bank support.

We have taken a provision of £3.2 billion in respect of PPI, but despite this provision we have maintained a strong capital position, and in terms of our first quarter performance our core business is performing but recovery is still fragile.

With that I shall pause and Kate and I are happy to take any questions you may have and I will hand you back to the operator to facilitate that.

Question and Answer Session

Question 1: Chris Manners – Morgan Stanley

Good morning Tim, good morning everyone. I just have a couple of questions for you. The first one was on the PPI charge. I mean it seems to be very large to us. I know the British Bankers' Association were sort of saying maybe a £4.5 billion total charge for the industry would be a potential after you had lost the Court case. I mean how did you actually calculate such a large number and you know, is there a potential basically that that number comes down because it is an initial conservative estimate?

The second one was on the net interest margin, just trying to understand is it the funding cost that has gone up? Also just on the asset pricing dynamics, I guess we have seen Santander UK say that asset pricing has stabilised for them. What are the moving parts in that net interest margin that has caused that to come down quarter-on-quarter? I thought that previously the guidance would be around flat. Thanks.

Answer: Tim Tookey

Okay Chris, let me take your questions in the order you asked them. If I miss a bit come back to me. As far as the PPI provision is concerned, this is the provision that we regard as our best estimate for the potential cost of customer redress, including the administration of the customer contact programme that we will now undertake. It has been calculated and reviewed in detail by management and of course discussed at length with the Board. And it reflects the considerable discussions that we have had with the Regulators about the appropriate application of the Policy Statement 10/12 which has been the subject of so much debate in the industry. So we regard it as a very well informed provision. But by taking this at this time, we think it is the sensible, the prudent and the right thing to do. What it will do is provide certainty for our customers and shareholders and is definitely in the best long-term interest or the best interest of the long-term stability of the business to be clear on what we think the financial impact of the exposures is. What we now want to do is to begin the work to bring about the final resolution for all of our customers that are affected.

As far as NIM is concerned, you asked about margin. Chris you are absolutely right to have identified that the largest impact on the margin is around the cost of funding. I said at year end and in my opening remarks that we saw there being limited further asset repricing opportunities in the first quarter. Having said that, we have seen some and we have achieved some asset repricing benefit. But the main impact on margin has been what we have seen on funding.

Further Q

Is that more wholesale funding or is it on the deposit side? I saw for example you put in this quite competitive product, one year deposit at Halifax at 3.35%. Which bit are you seeing the most pressure on?

Answer : Tim Tookey

I think most of the pressure is coming here from the wholesale markets. The retail deposit space continues to be pretty competitive as I have said. I think we have had a very successful deposit raising quarter. We certainly haven't been paying the top rates across the industry for things. We have had a very good ISA season for example but we haven't been offering the best rate. What we have been offering is the best overall product. So it is a competitive market out there. But it is the right thing to be doing to reducing our dependence upon some of our funding sources. What you saw in the announcements back in the start of March is the positioning of the Group with a multi brand strategy and very much looking to develop the Halifax as the challenger brand. And that is exactly what it has been doing. It has been challenging. But I would say, if you looked at for example, the ISA rates that have been out there, we have not been paying the top rate on ISA's. What we believe we would be doing is offering the best overall product and service.

Chris Manners

Fantastic, thanks Tim

Question 2: Leigh Goodwin – Citi
Morning guys, a couple of things please. One was on the reduction in the Government's sponsored funding, just looking at those charts, very helpful. I think you said at the year end that of the other element, the non CGS, the lion share of that was, I know you couldn't confirm, was SLS because the other bits, the central banks sponsored funding I think from the Australian Federal Bank was minor. Is that still the case? And in other words should we still assume you are getting minor support from those other sources and therefore the SLS remains the largest element of the reduction in central bank or Government sponsored funding?

Answer: Tim Tookey
Leigh thanks for the question. Actually I think it will take you a few minutes to unravel the footnotes on the slide there. Actually the Reserve Bank of Australia funding matured during the quarter and of course was repaid in full on its maturity date.

Further Q
So there is now all SLS, is that the way we should interpret it?

Tim Tookey:
I have got £44 billion of CGS outstanding as part of my £70 billion and I have no facilities from other central banks around the world.

Further Q
So SLS has repaid by the look of it, halved in the quarter. The other question I had was just in relation to consensus. I think you kindly gave us a couple of days before an idea of where consensus is for the year, I think about £4.4 billion for this year, at the combined businesses level. I mean a lot of moving parts today, one-offs and then margin movements. I wonder if you could give us a sense of where you think consensus might move to after today?

Answer : Tim Tookey
That is a broad question. Why don't I have a stab at it. Your comments about where consensus was. I think you are right, it was around about £4.4 billion, but there were two or three particular outliers out there. I think if you excluded that you would have lopped off £200-300 million from that for a start. So I think that would be where I would start from. What you have also seen us do today is give you specific numbers on what is happening with the ECN mark-to-market on the equity conversion picture in the ECN's where we are about £400 million off in the first quarter. This obviously is something that can't be predicted, but it would be inappropriate for us to exclude it from the underlying income at this time. So that has to be taken into account. I can't promise that that number will stay the same for the rest of the year, it could go up or down.

Obviously then Ireland is part of the equation. We are taking a more prudent position on Ireland. We are including provisions that anticipate potential further falls in commercial real estate of another 10% in Ireland. Those asset valuation falls haven't yet happened, but I have been very clear with people. We have got a troubled portfolio and a troubled economy and I think it is important to maintain a prudent stance there with valuations and how we reflect that in our impairment provisions. So that is new news if you like back at the consensus view point on the current year.

Where else would I then go? If you then look at what is happening in the core business. Okay, so you have got those easy to spot items. In the core business we spoke at the year end of the environment in which we thought we would see no further progression than net interest margin. We are 3bps off that in the first quarter from wholesale funding predominantly and I think some of the headwinds that we are facing on margins will continue. I think in the calls that the team have been having with various of you this morning, I think the emerging view from your world, if not from my world, is there is likely to be a handful more basis points coming off the margin if these headwinds persist.

And of course, we are also seeing what I would regard as a very pleasing reduction in the size of the balance sheet. But that obviously affects the size of the balance sheet you are applying your P&L factors to. So those for me Leigh I think are the big items that are happening in here.

There has been, I know there is some confusion around the Treasury assets and people have started to ask how this works. What we have done here is liquidate nearly £11 billion of Treasury assets and we have done it by taking a loss on disposal at the profit line of less than £30 million. That gives me huge comfort over the marks that we are carrying on these things. But of course what it does do is it sucks forward some of the future fair value unwind that we would have had on these assets if they were held to maturity. In fact the impact of that on the rest of this year's fair value unwind would be a couple of hundred million. So you need to factor that in. So we have this strange situation where you have a virtually nil profit or loss on disposal, but simply for the rest of the year, I forego because I have already had it, about £200 million of fair value unwind. So that is in the IMS today, that is another thing to take into account in your models.

I hope that gives you the big items as I would see it.

Further Q
Yes that is very clear, it seems to be mostly sort of one off things that I identified in the first quarter, but then we have got to factor in a slightly lower margin and interest earning assets and then this fair value unwind effect. I think that is basically what you are saying?

Answer: Tim Tookey
Yes I mean it is a difficult one to peel back the layers of the onions and I am dead against introducing more sort of underlying measures in here, because I think that ends up really confusing. But what I did set out on Slide 9, was actually, if I looked at total income quarter-on-quarter you think you have got a 12% reduction. You take out the ECN movement, it is 9%, take out the loss on Treasury assets. That element of the Treasury asset disposal impact that has to be accounted for in income, then you have actually only got a 2% decline. And I have got a 3% reduction in the size of the balance sheet, which actually tells you okay, well there's the evidence coming through of a little bit of asset margin expansion must be supporting that, because a 3% smaller balance sheet is only giving you a 2% reduction in income.

Further Q
Yeah but by implication of the other operating income ex the items you have mentioned, the ECN and Treasury write-downs, that must be holding up okay, by implication, is that broadly correct?

Answer: Tim Tookey
Yes it is. I mean in fact in the first quarter, the other income excluding the ECN's is £2,086 million but that bears the £426 million odd of losses on Treasury assets. So you get back to about £2,512 million. And £2,512 million would compare favourably with what we have seen in the last quarter of last year for example, or 12 months ago it was £2.6 billion. So you have got the same kind of dynamic here of quarter-on-quarter mainly driven by size of balance sheet. Obviously NIM doesn't affect other income. The main driver being size of balance sheet.

Leigh Goodwin
Okay that's very helpful, thanks Tim

Tim Tookey
Okay, thanks Leigh. If you get confused when you model it up you know where we are.

Question 3: Jonathan Pierce – Credit Suisse

Morning Tim. I have got a couple actually. The first one, can I just clarify what you were just saying on the fair value unwind. Are you saying the full year unwind will still be around £2 billion and £600 million for next year?

Answer: Tim Tookey

We are saying we have sucked forward about £400 million of unwind on the Treasury asset losses of which £200 million is given up in the current year. So therefore you have got a £200 million adjustment to our previous statements on fair value. You will be net £200 million ahead on fair value give or take.

Further Q

Is this sort of process going to continue or are you likely to be exiting these non core Treasury assets roughly in line with book moving forward? So any fair value unwind will be largely netted off by losses on disposal?

Answer: Tim Tookey

I think the strategy that you have seen us deploy in the first quarter has been to create funding flexibility to accelerate Government pay down. And to create that by looking at assets which we could sell at our marks. And we have been successful in doing that. I think it is quite possible we will do a little bit more of that as we go forwards. If we find that prices are sensible and prices are attractive and we have got a sensible use for the funds. It is all part of the derisking, it is all part of recognising the Group has to get onto a footing where it supported by proper sustainable third party funding sources be they deposits or wholesale funding. And we have got to move off having the central bank liquidity support that we have had. We have got to get the place clean, get in place more of the foundations for taking the Group forward. So if opportunities arise Jonathan then I wouldn't rule it out.

Further Q

Thanks. Coming back to net interest income. If I look, and thanks for the quarterly disclosure. If I look at the quarterly progression, in the last five quarters, it has come down by about £100 million a quarter. Although it seemed for some reason to spike up in the fourth quarter of last year which I thought was slightly strange. So maybe you could just start by telling me why there was the spike in Q4? Obviously it helped your margin in the second half of the year was up. But not particularly representative though of the proper trend. Just strikes me it looks like some sort of accounting pull forward in Q4 of last year?

Answer : Tim Tookey

There is nothing particular in there that would feature in underlying. We did have a particular spike in the fourth quarter from banking volatility. So this is the accounting for hedging effectiveness. That will be the reason for it. There is nothing there in that trend that would otherwise cause me concern necessary to guide you on Jonathan.

Further Q

And is that how we should be thinking about over the next few quarters then maybe, somewhere between £50-100 million per quarter drop in the net interest income quarter-on-quarter?

Answer : Tim Tookey

Well I appreciate your comment thanking us for the quarterly disclosures. Remember of course that for a while we resisted this because this is not a business that is managed around a sort of quarterly cycle. So there will be some reasons why income trends will be different quarter-on-quarter. We are not going to get into quarter by quarter guidance. What we have talked about though is some of the headwinds that we expect to see that may affect the margin going forward, as well as the fact that if we still see continued subdued economic activity, then we may not be able to grow the core book as much as we would like whilst we are running off non core. If you looked at core loans and advances, they are actually flat at the end of March from the end of December. I would love to have seen some growth in that.

Further Q

Okay, final question on expenses. If you annualise the first quarter in the expense run rate it is just over £11 billion and that is pre any banking levy so far. Do you see scope to improve the underlying run rate in that as the year progresses? And maybe you can give us a bit more flavour on the extent to which the financial services compensation scheme costs will affect the underlying expense number as the year progresses?

Answer: Tim Tookey

Yeah sure. I mean expenses are 1% down on consecutive quarters. What that shows you is the substantial part of the growing synergy delivery is being absorbed by either targeted and specific investments or a degree of natural cost inflation. We are of course seeing the start of the extra costs around national insurance and VAT come through. So we are in the strange position of not being able to account for the first quarter of the bank levy. I still say that we expect costs to be broadly flat for the year. And that includes the impact of the bank levy. So there is no change in our positioning on expenses at all going forwards.

Jonathan Pierce

Thanks a lot.

<u>Question 4: Jason Napier – Deutsche Bank</u>

Good morning Tim. Just a number of brief questions if I may. First one clearly going to be the biggest question of the day. You have said that you expect some of the headwinds in relation to margin to remain for the rest of the year and you also said in relation to consensus that you know changes happening in our world if not in yours. Could you clarify which of the headwinds you wouldn't expect to persist through the year and be explicit as to whether you are saying margin will be flat this year or whether you are in fact saying that it ought to be down?

Answer: Tim Tookey

Hard to pick on the headwinds, I guess if I could predict those I would be doing a different job Jason. I think the, let's just talk about wholesale markets. Wholesale markets have been remarkably open in the first quarter. When you think we have been through New Zealand earthquakes, natural disasters in Japan and close to nuclear disasters, all the troubles of North Africa, European sovereigns, Irish economy. And I haven't even mentioned the UK yet, and the impact of the austerity measures and concerns over you know will the economy double dip or not? But those kind of effects last year actually caused wholesale markets to have some pretty nasty effectively closed periods for term issuance in May around Greece concerns, and then in the autumn with Irish concerns. So the markets have been remarkably resilient in the first quarter, albeit they have been expensive. Because of concerns over how those markets will be for the rest of the year, it was the right thing to do to bring forward some of our issuance into the first quarter and thereby if you like, remove the risk of markets closing on us and us actually missing some of our funding targets for the rest of the year. By bringing that forward, obviously I introduced more cost and therefore potential margin drag into the current year. And if you like some of that drag is effectively on the books already because I have done the issuance, but you can't see it yet because I have only got you know probably less than a quarter's impact on the margin.

Those are the kinds of things that I am alluding to, but I think the one or two analysts in the early morning calls this morning in asking whether the NIM drop should be multiplied by four for the year. And I would say no to that. That is not something I am thinking about, it is not something I am looking at.

Further Q

Thank you. Second one is, the statement alluded to further costs to come from the FCSC?

Answer: Tim Tookey
Yes sorry you did ask about that, and actually so did Jonathan. I am sorry Jonathan I forgot to answer that part of your question, so Jason thank you for picking me up on that. The FSCS costs that we are alluding to are the costs of any shortfalls as the compensation scheme actually goes through the rundown of the businesses that it has with it. And those shortfalls are of course picked up by the banking industry. We make reference at year end to the fact that we had expected some of these costs to come through during 2011 and that we would show them below the line. In actual fact in the first quarter, you know we have only picked up about £20 million of those costs and I haven't pulled them out below the line. I can't pull out £20 million item below the line can I Jason. Those are just upstairs in normal costs as a bit of noise. But if this picks up during the year then I will do what I said I would do at year end and we will call it out. But then I would exclude them from the normal expenses line. And I would exclude them from cost/income ratios and you know all sorts of other guidance etc.

Further Q
But it wouldn't be more than a couple of hundred million would you think?

Answer : Tim Tookey
I don't know, it depends on the performance of the books that are being managed by the FSCS which is why it is difficult to predict as to timing, never mind quantum.

Further Q
Okay. The last one, the combined business PBTFI, if I add back the things we couldn't see, the sort of net loss on Treasury assets, the ECN and the £70 million out of New Zealand. It looks like it is annualising at about £3 billion. And even if we do take off a couple of hundred million for consensus, combined business PBT, it looks like you are about 25% below the full year consensus figure. I just wondered whether you might comment whether there is anything wrong with that algebra? And secondly whether you could just give us an update at 2012 combined PBT consensus number?

Answer : Tim Tookey
Jason, we will circulate the CD Rom with the business plan on it later. Let me answer your question. I tried to sort of walk down guidance how I saw it in response to Leigh's question at the top of the call today. So I think you picked up most of the points there. I think the other points I went through with Leigh was actually reflecting on the overall size of the balance sheet. And I am not sure you had that did you in getting to your point. You are probably thinking about that slightly differently to the way I am.

Further Q
I am just trying to get to sort of what sort of clean first quarter combined PBT was and it looks like it was £800 million for the quarter. And if the balance sheet shrinks then you know that number presumably walks down in the coming quarters unless there are other one-offs that we can't see?

Answer : Tim Tookey
Well the items that are there in the first quarter, obviously you have got the ECN movement which you picked up. You have got the additional Irish position and Ireland will continue to be difficult to predict. And then you have got the Treasury asset bit which is you obviously need to split it between the funny accounting on the loss on disposal which is small at the profit level, with the future fair value unwind gone. Then I think you just need to reflect on what you want to model for margin and then the size of the balance sheet to that.

As far as 2012 Jason, we are not talking about 2012 today. We are really here focusing on the first quarter, the trends we are seeing, the environment in which we are operating and the impact of that on short term performance.

Further Q
I was just more interested in what consensus combined PBT was if you had that to hand?

Answer : Tim Tookey
To be honest I don't for 2012. You have it?

Kate
7.6

Tim Tookey
Okay, it's 7.6 at the moment.

Jason Napier
Thank you

<u>Question 5: Michael Helsby – Bank of America Merrill Lynch</u>
Hi morning Tim. I have got maybe three questions actually. First on the PPI provision. Can you just tell us what period you have gone back over in terms of date years when you have set up the £3.2 billion provision? And also I am very mindful of the fact that you did a hell of a lot of restructuring at the back end of last year. So could you tell us what the NIM impact there was always going to be in the first quarter, just as a function of all the funding and the non core run off and the central bank repositioning you did in Q4 of last year?

And then just lastly on bad debt. I guess you have clearly taken a £500 million top up on Ireland. You have just described it as being difficult to predict. It strikes me that this is the first time you have really tried to get in front of the issues in Ireland, so it doesn't sound like you are going to give a view, but it feels like timesing the number by four, i.e. the £1.1 billion, is the wrong answer. So I was just wondering if you could give us any comment on that because clearly to Jason's comment, that is the big swing factor in the Q1 results?

And then as an aside to that, I was wondering if you could give us an update on the UK bad debt. I hear what you are saying on mortgages, I think that is clear. But the wholesale bad debt charge actually looked better than what I was looking for and I am just mindful of the fact that you had flagged that you expected a deterioration in commercial and maybe CRA to continue to improve. So I was just wondering if you could give us an update on that, how you saw it this quarter and also on any forward looking indicators on your SME commercial book, has there been the degree of deterioration that you thought you might see?

Kate
That was seven questions Mike.

Answer : Tim Tookey
Are you done Mike?

Mike Helsby
Yes, sorry.

Answer : Tim Tookey
So could you just repeat them? Okay I think I have, well Kate got seven, I only got six written down here. We will see where we get to. I am sure you will remind me. PPI you asked about periods. Obviously the policy statement and the way in which the FSA wish banks to handle PPI complaints going forward, actually covers all periods in which these policies are being sold. But obviously there are different practices and procedures that will be put in place for different periods. So we have had to reflect on how you know complaints covering all periods would be handled and that is how we have done it and built the provision up.

You then asked about restructuring last year and then you clarified it for me, because I was trying to wonder what it was, about the margin. And the impact of the funding last year on this year's margin expectations in Q1. For me that is probably only a couple of bps worth of impact in the first quarter. Q4 last year to 2.12 per cent on its own and obviously full year last year 2010. So I have that in my mind you see when I was talking and being really, really clear about no further margin progression for this year. So I hope this gives you the guidance on that.

You then went on to talk about Ireland and the 500 top up. Yes you would be wrong to take the £1.1 billion for Ireland and multiply it by four for the full year. That would be the wrong way to think about it because what we are trying to do if you like is recognise the additional provision requirements from a further commercial real estate property price fall and get the vast majority of that into Q1. The big issue of course in Ireland remains liquidity. You know you could not sell a perfect piece of prime real estate with a prime tenant for what would be considered a fair price. At the moment in Ireland there is very little liquidity. And the economy itself remains you know quite difficult. You know in March their fourth quarter GDP was published and consensus was minus one for the fourth quarter of last year. And actually GDP contracted by 2.1% was published in their numbers at the end of March. On top of that unemployment ticked up above everyone's expectations. It hit 14.7 against consensus for unemployment of 14. So this economy I am afraid has still got a number of issues that it has got to work its way through, and that doesn't mean that there is going to be any accelerated recovery that is going support our active management down of our exposures in Ireland. It just makes me gladder that we took the decisions last year to get out of Ireland, close the business, give back the banking license. We don't employ anybody in Ireland anymore. So we have taken the right actions. We are now actively managing these assets from the UK.

You then went on to talk about UK impairments. So let me just walk down those. As far as the retail book is concerned, it is doing what we thought it would do. We are seeing a small increase in the run rate of secured impairments. That is in line with our thinking around house price moves and relatively stable unemployment levels so far. We are also seeing a contraction in impairments on the unsecured book. Remember this is a much younger book, so this benefits from some of the risk actions put in place over the last 2-3 years. So in an environment where we are seeing unemployment do what we thought it would do, we are seeing the expected contraction in impairments from that portfolio. And as we thought would be the case for the full year, when we guided on this in February, the benefit from lower unsecured is bigger than the additional charge from higher secured. So retail as a whole comes down.

You then in question six I think, went on to talk about wholesale and SME. Wholesale impairments are of course lumpy and they are difficult to predict between quarters. So we will guide on trends in the future. I am not going to get into specific quarters. But the one point you did say, maybe this was the seventh question, was around trends in commercial. I still think as we have got a fragile UK economy, there is a chance that your normal traditional trading manufacturing businesses will see high levels of impairment just as you normally see when you come out of a period of recession. That is a pattern we have been talking about for over a year now and I know this must look like a wave that never quite reaches the beach, but it is still something we are concerned about for this year. So no change therefore, no update on what we think for the full year on those types of impairments. So overall, the impairment story is pretty much what we expected with the exception of Ireland.

I hope I have covered everything.

Michael Helsby
Yeah, that was perfect. Thank you.

Question 6: Manus Costello – Autonomous

Morning everyone. I have a couple of questions please. Firstly can you explain why RWA's aren't going down for the rest of this year? You talk about model changes but I don't fully understand what those are and does that mean that £60 billion of non core WRA reduction you are hoping for by 2013 is at risk?

And my second question is just coming back on this fair value unwind guidance, a favourite topic. The way you have explained it Tim by saying you are selling the assets where you have marked them and you are happy with that, it almost sounds like you think those assets are correctly marked at that level. But the fair value unwind guidance assumes that those pull back up to par. So can I just understand again just following up on Jonathan's question. Should we consider the fair value unwind guidance, the accumulative amount you have given us over the next few years, are you thinking of that as kind of money in the bank for you to spend on additional Treasury sales? Because all of the numbers that we have looked at and we have talked about on the consensus basis are always on a post fair value unwind basis. So I am a bit confused at the way you have explained it now?

Answer: Tim Tookey

Okay. Manus thanks for the question. Let me break it down. We are still going through a lot of integration work. Therefore we have still got a lot of modelling work that is going on on the balance sheet and alignment of systems and alignment of how we approach the WRA modelling for different parts of the book. We will see some further improvements and alignments of models over this year. They are relatively small scale, but I think that will probably slow down or offset the RWA reductions that we are looking at for the rest of this year. Clearly we could do better than that if we do better than what I am thinking of for non core asset reductions or indeed we are not able to grow the core business by as much as we would like. What I am trying to do is manage expectations around what the overall profile will be here of RWA's as we go forward.

You then said, should you be concerned about the RWA reduction that we guided to at year end? That guidance we gave was specifically in the context of saying what will be the RWA benefit from our run down as we move through the next few years getting ready for Basel III to come to us. And that gave you an illustrative capital ratio for the date at which Basel III gets implemented. I have always been very clear that what that showed was that there was considerable core tier I capacity for higher levels of risk weighted asset to actually support the income growth that itself is necessary to drive the earnings that give you that ratio in the first place. So I am not concerned.

Further Q

But did that £60 billion include model changes?

Answer: Tim Tookey

No, that £60 billion was illustrating what achieving 95 out of the 195 non core asset reductions would do at their average risk weighting. If you remember Manus at year end we said that RWA's, 35% of our risk weighted assets came from non core assets and we had £195 billion of non core assets left to go and we wanted to get rid of £95 billion by the end of 2013. So it simply takes 35% of 95 – 195 bps of the 406 risk weighted assets we had in the balance sheet and that gave you 67 and I rounded it down because I am always a bit prudent.

Further Q

No I understand, it is obviously a critical part of the investment case we are all hoping for RWA's to come down, but if the base is substantially higher or if there are model changes we are not aware of then even those illustrative examples could lead people to incorrect conclusions about where you might be able to get to in a couple of years time.

Answer : Tim Tookey
I think what I am trying to do is just put a little bit of a break on some of the expectations that we have seen in some of the models. Clearly we will be saying more about this at the end of the strategic review period at the end of June. So don't concern yourself overly. There will be greater clarity obviously when we finish the strategic review.

You then went on, briefly Manus because time is running against me. You ask about Treasury asset sales. It would not be correct to say that we had assumed all the assets were pools apart. The fair value provisions taken may have been to reflect the fact that we would only ever assume that the asset came back to say 80 or 90. So by selling the assets early, yes of course we forego the external income earned from those assets. But I also avoid the need to fund those assets. And that gives me greater funding flexibility or indeed funding capacity to grow my core business which is what I really want to do to gain and build those sustainable types of profits and earnings which will support real long-term value creation which is what we are all looking to achieve. Fair value itself is of course a zero sum game over time. We have shown you it is hard to predict, if you think back to 2009, we thought we would do about £2.5 billion of fair value credit, we ended up at £6 billion. That reflected additional impairments triggering the acceleration of fair value unwind.

The Treasury assets is a little micro example of the same thing, which is why I felt it was the right thing to do to tell you today that we have sucked forward £200 million of the fair value that would have otherwise have come out just in this year. And obviously the other £200 million would have been in the future, depending upon the contractual maturity date of those assets. Does it mean we have therefore got I think using the expression like sort of money to play with? I don't know, I think the answer to that is yes and no. I am mindful and I have said this at year end, of the balance that we look to take when balancing the benefits from capital reduction and funding flexibility from running down non core with the damage that you could do to your capital base if you decide to sell things and take losses on them. We will look to get that balance right and it is sometimes a different balance with different classes of assets and different situations.

Manus Costello
Okay, that's interesting, thank you.

Question 7: Steve Hayne – Morgan Stanley
Good morning, thank you. Could I just follow up again on revenue. In particular we have heard the comments you have made about margin and will take that on board. Just in terms of the non core asset run down, I mean that is an area that seems to be going relatively well. You have taken it down to 174 in March from the 195 at the end of December. Where do you see that ending up by the end of the year? First question. And linked to that, therefore where do you see your average interest earning assets going over the course of 2011? Thank you.

Answer: Tim Tookey
Steve hi, thanks for the questions. I think at year end we were often talking about 95 to go, three years to do it. Excuse the roundings. £32 billion per annum, how would I feel about £32 billion? I said I would feel quite happy with £32 billion. You have seen us achieve £21 billion of that in first quarter, but we have had the benefit of markets being receptive to taking from us quite significant volumes of assets over and above what our original expectations were. So we have made exceptionally good progress. Please don't take a £21 billion reduction in a quarter and multiply that by four and say the whole thing is going to be done by the end of this year. That would really be most unwise. Should you still have £32 billion in your models if that is what you had Steve, I don't know. I think for us only to do another 10-11 for the rest of the year I think would be pretty disappointing, but I would therefore think it would not be unsensible to assume that we will do more than the £32 billion which is a straight line effect. What that will do is it will of course mean that we have a smaller balance sheet. Now remember the Treasury asset pieces don't count towards average interest earning assets.

They count towards that bit of net interest income that comes in the line on Note 2 of the IMS at year end, the full IMS at year end which comes through in other non banking including trading net interest income. So the impact of that comes through in there not through an average interest earning assets. If you actually look at average interest earning assets, they are actually down by a much more modest level quarter on quarter and that reflects just the loans and advances element of non core run off which from memory is on page 12, my non core are down £7 billion from £139 to £132 billion, that is my loans and advances which is obviously the primary driver of average interest earning assets for the Group. Not sure I have hit the spot Steve.

Further Q
So I am just seeking a number in terms of that interest earning asset. So at the average interest earning assets was what £629 billion fourth quarter 2010, now down to £612 billion. Should I be thinking of a number south of £600 billion by the end of the year for the course of 2011, it sounds like it?

Answer : Tim Tookey
Look if we continue some of our non core work then you could get there. However actually when you look at the strength of our funding position and our strong capital position, we actually would love to see our core business start to grow more. We have seen growth in our SME lending over the last year, but actually overall loans and advances in the core portfolio are flat on year end. I would actually like to see some growth in that. So that would mitigate but not fully offset the kind of reductions you are talking to.

Further Q
Okay, can I have one other quick follow-up which is not really a follow-up but in terms of the LTV's across your book. We have obviously seen that getting a little bit better. House prices have recovered off the extreme dip we took a couple of years ago. House prices now seem to be drifting down as you have confirmed as well. How do you see that playing out in terms of, you would have thought your average LTV's etc across your book are going to start drifting up again, and what implication that has for part of your A weightings coming back to another question you had today?

Answer : Tim Tookey
Yeah, sure, well we have set some information out on the bottom of page 8 in the IMS to help you a little bit with this. I am not sure it would answer Steve all of your question. The proportion of the book that has got an index loan to value greater than 100% actually increased by 0.3%, it is at 13.5 up from 13.2%. But actually the value of mortgages that are more than 100% and that concern me because they are more than three months in arrears is actually pretty stable at £3.3 billion. You know that is less than 1% of the portfolio and only up slightly on year end. The LTV's around new lending are pretty consistent with the numbers that we were seeing for last year as a whole. So that doesn't concern me. But if we do see a drift down in house prices, then there is a direct read across into risk weighted assets. That will be part of the overall comment we have given on RWA's in answer to Manus' question a few moments ago. There are a number of dynamics in there which I didn't want to set out in full in the IMS, but clearly what happens in the economy is part of it.

Steve Hayne
Okay, thank you.

<u>Question 8: Arturo de Frias – Evolution</u>
Hi Tim, Good morning. One question. When I look at the, all the news that we have heard today, it looks like you have done a lot of things that you probably didn't necessarily have to do in this Q1, and by this I mean obviously PPI's is needed because we have the decision by the Court, but I don't see the need to model particularly in Q1 another 10% fall in commercial real estate by Ireland, you didn't need to sell £21 billion of non core assets which is twice the run rate of 2010.

I appreciate your comments about the situation of the funding markets, but you have issued £13 million in Q1 which is again twice the run rate of 2010. So it seems you have done a lot of things in Q1 that you probably didn't necessarily have to do. My question is, my only question is, is all this the result of a very clear top management decision of bringing forward as many bad news as possible to Q1? And if that is the case, I would like to understand why and I would like to hear your view in terms of is Q1 going to be clearly the worst quarter in 2011 and we are going to see from now on probably more good news than bad news because it seems like all the bad news has been shown in this quarter? Thank you.

Answer: Tim Tookey
Arturo, thanks for the question. I don't think you should see this as having sort of sucked all the bad news into Q1. I think I would rather position this as us doing the right things, reflecting what we are seeing going on out there in the markets in which we operate. So yes you said PPI was one of the things you needed to do. I would agree. We have had so much uncertainty around that for so long, that being able to draw the line in the sand of it, avoid a long running dispute with our Regulator, take the right provision and get on with it is the right thing to do. And I don't enjoy for example having to write what I did at year end about PPI could have a material impact on our financial position. There was so much uncertainty, couldn't do or say anything else. Now we have greater clarity, is the right thing to do is to make the provision and now get on with it.

In terms of doing things that we didn't need to do. It is an interesting way to look at it Arturo, but perhaps you won't be surprised if you don't mind, that I don't share your perspective. You see, reducing the non core assets is something that has to be done, it is a question of timing and getting the value created versus the value destroyed balance correct. The term issuance has got to be done this year, but what we saw in the first quarter was an unusual global cocktail of natural disasters and economic uncertainty and sovereign concerns which, when you think about what happened twice last year in terms of term markets effectively closing, meant that we wanted to get ahead of any kind of impact that could come on us were we to see markets really close up again because of those types of concerns really contaminating markets. It made funding a little bit more expensive and I apologise for that, I can't control pricing. But the conscious decision to go and do it was right. By paying down some of our early central bank and Government funding sources early, we are doing something that has to be done, those are non sustainable funding sources. They were put in place as medium term finance a few years ago. We want to replace those with medium term finance to the extent that we need to replace them bearing in mind I will have less funding in the future because I will have a smaller balance sheet. So it is all about, it is as much about timing and by sorting these issues out now we are going to bring forward the date upon which the balance sheet is cleaner and the business has got stronger foundations in order to move forward under whatever strategy comes out from the strategic review that is currently ongoing and will be communicated to market at the end of June. And it is around putting those foundations in place.

Further Q
Sure. Don't get me wrong. I fully agree with you that all these things had to be done along the road. But what I find very interesting is the speed at which you are doing things. I mean again, the funding under sale of non core assets you have doubled the run rate of both things versus 2010. I mean 2010 the run rate of 2010 was already fast. So that is what I find interesting.

Answer : Tim Tookey
I think there is a series of conscious decisions here that we are taking about doing the right thing, making sure we are getting ourselves into a prudent and balanced position here. I absolutely agree with you that there are choices around some of these things, but I am keen that we continue to derisk the business and derisk the balance sheet. And I think, you know this won't affect the prospects for the Group in the medium term under whatever strategy we present to the market at the end of June. What it will do is bring forward the date upon which we are clean and able to move on.

Arturo de Frias
Okay, thank you very much.

Question 9: Rohith Chandra-Rajan
Hi, thanks very much. Good morning. Just one from me. I am particularly conscious of time. Just bearing in mind your comments on the margin which if I have understood them correctly are for some decline from here, but we shouldn't annualise the 5 bps in the first quarter. And then also thinking about the non core run off. I know you are cautious about giving guidance, but just on the assumption that there is £26 odd billion of non CGS funding, Government backed funding still out there, that might perhaps be the pace of non core disposals for the remainder of the year. Maybe a little bit above that. I was just wondering given those two things and also the sort of items you have highlighted in the first quarter, your degree of comfort with the £22.6 billion consensus estimate for revenues for this year?

Answer: Tim Tookey
Thanks for the question. I am not sure on your last point, I can add much more specificity compared to the questions I took from Leigh and I think Jason earlier in terms of how I see consensus. There are a number of variables out there which, when we talk about an uncertain economic world are really quite difficult to predict. For example, Rohith, if we had had this call a month ago, you would have been asking me about the potential benefits to income of seeing three base rate rises this year? No one is asking me that question today because actually everyone is now thinking, well there probably will only be one rate rise. You know we factored that in for August time, within a month or two, who knows, time will tell. So it is a very, very uncertain world in which to give that level of specific comment. So I am not going to add any more on that. And I apologise, what was the first part of your question?

Further Q
It was really just to clarify the margin guidance?

Answer : Tim Tookey
No I wouldn't be taking the margin drop that you have seen and multiplying that by four. I have talked earlier on I think about you know a handful of bps potential impact if the current conditions that we are seeing you know continue for the rest of the year, I am not going to be more specific than that Rohith.

Further Q
Sorry, just to come back on that particular point, is that couple of bps a handful of bps per quarter or for the rest of the year?

Answer : Tim Tookey
Well I am holding my hand up.

Rohith
Okay. Thanks.

Answer : Tim Tookey
I am talking about full year.

Rohith
Okay, thank you.

End of Q&A

Closing Remarks

Thank-you very much indeed everybody for dialling into the call this morning. I hope you found it useful that we have expanded our disclosures this time and I really appreciate the opportunity and the very high quality questions you have given us.

As ever, message to everybody. If you think you have got further questions or when you write up your notes you can't remember quite what we said, please don't hesitate to contact Kate O'Neill and the IR team with your questions.

Kate
And I think we know that we didn't get a chance to address all the questions perhaps in the queue so please feel free to ring them through.

Tim Tookey
Thank you very much everybody.